Insurance Accounting Newsletter

Greater certainty on the roadmap to the new IFRSs comes with a likely end of IFRS-US GAAP convergence on insurance

The weeks that have passed since our last Insurance Accounting Newsletter have produced significant outcomes following an increased level of activity from both the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB).

The last decision in this period has perhaps the most impact as it significantly removes the uncertainty on the timetable for the adoption of the new IFRSs that will fundamentally rewrite financial reporting rules for insurance entities.

At their meeting on 19 October the IASB decided that they will not change the mandatory effective date of IFRS 9 'Financial Instruments – Recognition and Measurement' from the 1 January 2015. They also decided that the IFRS 4 – Phase II 'Insurance Contracts' will be effective approximately three years after its publication date. This is currently targeted for 2014 which results in a mandatory effective date of 1 January 2017 – one year later than anticipated prior to this recent round of decisions. The IASB acknowledges that this date may slip by a further year to 2018 if the final IFRS is released towards the very end of 2014.

The final draft of the new IFRS is due to be released in April or May next year and that will be the last opportunity for interested parties to comment on the proposals before they become mandatory. Comments will be invited using the IASB formal re-exposure process but they will be limited to five key areas.

From the perspective of the content of these final rules, the joint meeting between the IASB and the FASB on 24 September approved the long-awaited transition requirements, in particular considering the practical expedient for restating the residual/single margin for policies in-force at the transition date which would represent the major source of accounting profit under both the future IFRS and US GAAP. This issue is critical particularly for the life insurers.

Finally, the IASB and FASB joint meeting on 17 October approved the presentation of premiums and claims in the statement of comprehensive income with the 'Earned Premium' presentation being selected on the grounds that it was a better indicator of future performance and more consistent with 'revenue recognition' in other industries.

The roadmap to the new IFRS rules is set (IASB)

This was perhaps, the most anticipated part of the IASB meeting on 19 October where an indication of the future effective date could substantially address the timeline uncertainty insurers faced for several months.

The Staff indicated that they do not expect to publish the final standard earlier than 2014. Usually the IASB grants at least 18 months between the date of the standard's publication and its mandatory effective date to allow time to prepare for the transition to the new requirements. However, given the complexity of the proposed new insurance rules, the volume of data and tracking required, the Staff felt that 18 months would not be enough. Some respondents to the Exposure Draft in 2010 (the ED), mainly from jurisdictions already applying updated estimates and assumptions, stated that 2-3 years would be feasible while others asked for a period greater than 3 years between the issuance of the standard and effective date.

The Staff mentioned the results of the Deloitte Global IFRS Insurance Survey conducted on Deloitte's behalf by the Economist Intelligence Unit. The survey of over 200 senior finance executives from insurers operating in various countries across the world showed that approximately half of the respondents expected to need three years to transition to the new standard after its publication, and another 21% estimated they would need four years.

Based on all this information the Staff recommended a minimum of three full years between the date of the final standard's publication and its mandatory effective date. This would push the effective date to 2017, at the earliest. However, the Staff acknowledged that this could be as late as 2018 depending on when in 2014 the final standard is issued.

The Staff also recommended for entities applying the standard at the mandatory effective date that they would have to restate comparatives, and that early application of the standard should be permitted.

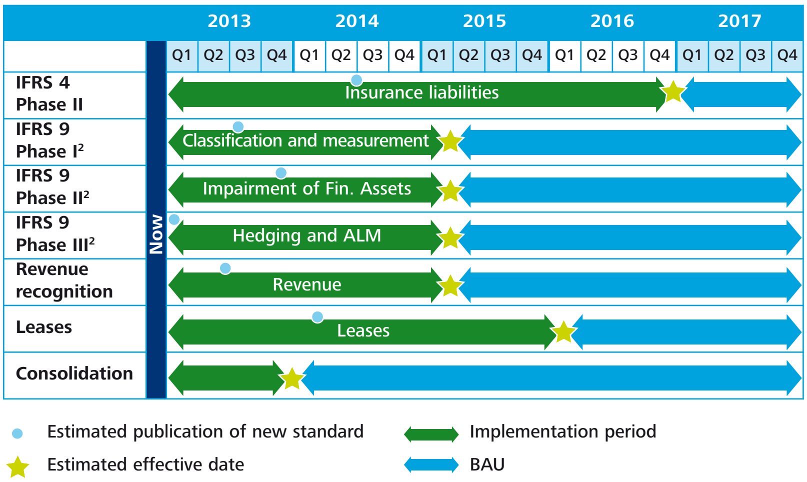
In paper 10E, used for this session, the Staff had originally proposed not to require the restatement of comparatives on early adoption because the restatement for the insurance standard, in the absence of early adoption of IFRS 9, would not result in comparable results. However, subsequent to the release of the paper and at the opening of the IASB meeting they withdrew their recommendation because they were subsequently convinced that restating comparatives would be critical to produce comparable financial statements at a juncture when so much change will be occurring in financial reporting for the insurance industry. Therefore the Staff proposed that IFRS 4 should always require the restatement of comparatives, including on early adoption.

As anticipated, the IASB discussion on the Staff recommendation was particularly lively with many IASB members expressing regret that IFRS 9 and IFRS 4 cannot be aligned. Many members including the Chairman wanted the adoption of IFRS 4 as soon as possible and they did not want to limit themselves by putting the words 'minimum of 3 years' in the tentative decision. Instead, they preferred a softer wording indicating that there will be a significant amount of time allowed for transition and that this would be approximately three years long (although some suggested that two years would be sufficient).

One member opposed both the misalignment of the effective date with IFRS 9 and the recommendation of an early adoption option because it would put pressure on those companies that chose to wait till the mandatory date suggesting to investors that they may have 'something to hide'. In addition, early adoption by some would reduce comparability across the entities until the mandatory effective date is passed. Others countered that there is no such comparability across the world now and therefore these concerns were difficult to support. The Chairman noted that the ability to adopt the new IFRS 4 as soon as possible is of utmost importance to preparers, even if there would be some decrease in comparability for a limited period of time.

The IASB voted 12 vs. 2 in favour of the Staff recommendation (including the requirement to restate comparatives in all cases, verbally presented at the meeting) subject to the words 'minimum of three years from publication date' being changed to 'approximately three years' or similar wording such that the IASB could make the new IFRS 4 effective as soon as practicable given all the circumstances noted in the Staff paper.

The arrival of the new IFRS stretches over a three-year period
A complex implementation journey



Notes

1. IFRS timelines presented have not been confirmed by IASB.

2. IFRS 9 Phase I – classification and measurement, IFRS 9 Phase II – amortised cost and impairment of financial assets, IFRS 9 Phase III – hedge accounting (excluding macro hedging).

3. New consolidation rules applies from 1 January 2013 if the insurer complies with IFRS as issued by the IASB (e.g. those with New York listing status) or as endorsed by the European Parliament (effective from 1 January 2014)

Transition rules for the opening balance sheet

Restatement of the residual/single margin (Joint – converged)

The Boards' decisions on the topic of transition were highly anticipated because of the impact they would have on the recognition of accounting profit, particularly for insurers with long-term coverage contracts. These discussions took place on 24 September.

The ED mandated no margin recognition on transition on the grounds that the margin could only be determined at the inception of the contract and would be too subjective and difficult to determine retrospectively. In particular, the determination of the margin would require assumptions based on a portfolio at inception which may differ from the portfolio of contracts in-force at transition. The overwhelming feedback to the original ED proposals from the majority of respondents clearly highlighted the concern that profits deferred under prior accounting policies for unexpired coverages would never be recognised in the income statement thus distorting the representation of economic reality in the financial statements.

In addition, both Boards shifted their view of the margin from being a mere balancing figure to one where it is more a measure of future profit that an insurer would earn as it fulfils the obligations under the various portfolios of insurance contracts it has issued. Based on this rationale the IASB has also tentatively decided to unlock the residual margin against changes in the estimate of future cash flows.

All these factors contributed to convince the Boards to embrace these concerns and to vote for full retrospective application on transition with a restatement of the margin (residual for IASB, single for FASB), unless it is impracticable to do so. They also agreed prescriptive guidance to offer a practical expedient for the restatement exercise.

While the efforts required from insurers are not expected to be exhaustive, there is a presumption that insurers would apply the new accounting principle retrospectively even in periods for which a detailed policy by policy restatement is not possible, provided insurers take into account all objective information reasonably available at transition for those prior periods.

Specifically, the Boards approved the Staff recommendation that at the beginning of the earliest period presented, an insurer shall:

i. Measure the present value of the fulfilment cash flows in accordance with the Boards' existing tentative decisions for measuring insurance contract liabilities;

ii. Account for the acquisition costs in accordance with the Boards' existing tentative decisions for acquisition costs and derecognise any existing balances of deferred acquisition costs;

iii. Determine the residual/single margin through retrospective application of the new accounting policy to all prior periods, unless it is impracticable to do so.

These strict requirements are mitigated only under the following scenarios:

1. If it is impracticable to determine the cumulative effect of applying that change in accounting principle retrospectively to all prior periods, the insurer is required to apply the new policy prospectively from the start of the earliest period for which retrospective application is practicable (i.e., apply retrospectively as far back as is practicable);

2. For earlier periods for which retrospective application would normally be considered impracticable because it would require significant estimates that are not based solely on objective information, an insurer shall estimate the margin through retrospective application of the new accounting principle taking into account all objective information that is reasonably available. In such cases, an insurer need not undertake exhaustive efforts to obtain objective information;

3. If it is impracticable to apply the new accounting policies retrospectively for other reasons, an insurer shall apply the general requirements of ASC Topic 250-10 for US GAAP and IAS 8 for IFRS relevant to situations in which there are limitations on retrospective application under approaches (a) and (b) above.

In addition to the above it was tentatively decided to add more disclosures:

(a) if full retrospective application is impracticable, the earliest practicable date from which retrospective application was applied;

(b) the method used to estimate the expected remaining margin for insurance contracts in-force as of that earliest practical date disclosing separately the extent to which the insurer has used objective information and separately, the extent of use of non-objective information in determining the margin;

(c) the method and assumptions used in determining retrospectively the 'locked-in' discount rate (see below on additional details for this requirement).

Extract from Deloitte Comment Letter 2010
"The ED's transitional provisions would be inconsistent with our recommended accounting model to recalibrate the residual margin as under the proposed transitional provisions no residual margin would be accounted for. We agree with the Board that a full retrospective application under IAS 8 could result in significant costs. However, we believe that establishing the residual margin of in-force contracts at zero at the date of transition does not represent faithfully the underlying economics (i.e., the profitability) of the in-force portfolio.

We would be happy to meet with the Board to discuss in more detail our recommended recalibration model, and its effect on the residual margin on transition relative to the model proposed in the ED. If the Board were to adopt our model, we strongly recommend that the Board carries out field testing to establish whether insurers could apply this model to a wide and diverse range of insurance contracts."

Discount rate on transition (Joint – converged)

The insurance model requires that for the liability measurement in the statement of financial position insurers use a current discount rate that reflects characteristics of the liability. Several approaches are allowed to estimate it, namely the 'top down' or 'bottom up'. However for the income statement the discount rate is 'locked in' at inception with changes to reflect current market interest rates accounted for in the statement of other comprehensive income ('the OCI solution'). Given the full retrospective application of the standard the Boards were called at their meeting on 24 September to decide the method to estimate the discount rate for several prior years.

The Boards discussed several options: 1) to use current discount rates observable at transition; 2) to use discount rates already used under local GAAP; or 3) to determine a range of discount rates in accordance with the standard based on interest rates observable in the respective prior periods.

The latter option was the preferred one because it was the most consistent with the full retrospective application. The Boards approved it unanimously.

To address difficulties in situations where there is no available data the Boards tentatively agreed on specific guidance to be applied when determining the discount rate retrospectively whereby an insurer should:

1. Calculate the discount rate yield curve in accordance with the standard and determine a market-observable yield curve (i.e., AA corporate bond yield curve) for at least the three most recent years prior to the transition date. If there is not a market-observable yield curve, determine the margin (i.e. an interest rate spread adjustment) between a calculated rate and the closest market-observable yield curve.

2. Use the same market-observable reference point to determine the yield curve (plus or minus a margin if applicable) for each of the years in the retrospective period (i.e., the AA corporate bond yield curve in each of those years).

3. Use that yield curve determined in the paragraph above for recognising interest expense on the accretion of the discount rates.

4. Record cumulative effect of the difference between those yield curves and the discount rate yield curve determined at the transition date to accumulated other comprehensive income.

Financial assets and insurance liabilities – Interaction of the effective dates (FASB and IASB)

FASB discussion

The FASB meeting held on 15 October dealt with the fact that the new US GAAP on Financial Instruments will not be concurrent with the new pronouncement on insurance contracts. For this reason the Staff sought clarification with respect to how insurers would handle the designation of financial assets assuming the new Financial Instruments accounting standard is effective before that on Insurance Contracts. The redesignation of assets is limited to only those instances in which the entity changes its business model and such changes are expected to be rare. However, the Staff noted there will be instances where as a result of the accounting changes, insurers will likely change their intent with respect to asset-liability matching as a result of the changes in the insurance contracts reporting model and in an effort to mitigate accounting mismatches.

The FASB tentatively agreed that on initial adoption of the new insurance contracts guidance, the insurer should be permitted to classify its financial assets in the same way as if it had adopted the relevant financial instruments guidance in effect at that date as if it was its first application. The effect of this approach should be reported as a change in accounting principle in the financial statements of the insurer.

The FASB also tentatively agreed that those financial assets that an entity can designate and classify on initial adoption of the insurance contracts guidance in the same way as if it had adopted the relevant financial instruments guidance in effect on that date should be limited to financial assets that are designated to the insurance business either by legal entity or by internal designation.

IASB discussion

The IASB discussed the transitional requirements and the interaction with the requirements and effective date of IFRS 9 Financial Instruments on 19 October. As noted above, the effective date for IFRS 9 is expected to be for periods beginning on or after 1 January 2015. However, the Staff outlined their expectations of not being able to align the effective date of the final IFRS 4 with IFRS 9 with the real possibility of the entities first having to adopt IFRS 9 for their financial instruments and then later adopting the insurance standard. Given that the two standards were developed with a view to eliminate possible accounting mismatches it was necessary to discuss how these issues could be addressed on transition.

In Paper 10C the Staff explained that IFRS 9 introduces new classification requirements for financial assets that the entity would apply on transition, initial application of the IFRS or initial recognition of a financial asset under the IFRS. Subsequently the entity can only re-designate financial assets if there is a change in its business model. In addition, IFRS 9 allows at initial recognition or on transition to irrevocably designate financial assets at fair value through profit or loss (FVTPL) only if the designation eliminates or significantly reduces an accounting mismatch. When the entity later transitions to IFRS 4 the absence of the ability to re-designate financial assets may create some new accounting mismatches. Equally, some previous accounting mismatches may cease to exist and they would no longer justify a FVTPL designation. Therefore the Staff recommended that on adoption of IFRS 4 an insurer shall be required to follow reclassification guidance in IFRS 9, except that an insurer should be:

1. permitted to designate eligible financial assets under the fair value option where new accounting mismatches are created by the application of the proposed new insurance contracts standard;

2. required to revoke previous designations under the fair value option where the accounting mismatch no longer exists because of the application of the proposed new insurance contracts standard; and

3. following earlier application of IFRS 9, permitted to newly elect to use other comprehensive income for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election if applicable.

The Staff reminded the IASB that for participating contracts the relevant component of the liability would mirror the treatment of the assets to which they are associated thus avoiding the creation of new mismatches.

One member queried whether the definition of an 'insurer' in IFRS 4 would award the re-designation to any entity with any number of insurance contracts issued thus creating an opportunity to re-think IFRS 9 classification even for entities that have issued only a small number of such contracts. The Staff agreed to amend wording to be applicable to an entity whose financial results are affected by the new insurance standard.

Other IASB members wondered whether the IFRS 9 classification change as a result of a change in a business model which may occur at the time the insurer transitions to IFRS 4 should be treated as a re-classification or should it be allowed to apply retrospectively. The Staff confirmed that because of the different effective dates of the standards any change in business model occurring after initial application of IFRS 9 would be accounted for under IFRS 9 prospectively. The IASB members noted that FASB have tentatively decided to permit insurers to classify financial assets at amortised cost, FVTPL or FVOCI, as if IFRS 9 had been initially applied at the same time as IFRS 4. Under the FASB approach insurers would be able to apply classification criteria of the financial instrument standard as if it was applied for the first time, rather than the reclassification criteria, as was proposed by IASB. While acknowledging this difference the IASB members approved unanimously the Staff recommendation.

IFRS transition – Ancillary issues (IASB)

In the meeting of 19 October the IASB also covered the treatment of changes in estimated future cash flows and experience adjustments when determining the residual margin on transition (Paper 10D).

At their September meeting the IASB agreed on the retrospective restatement of residual margin on transition, while previously it agreed on prospective unlocking of the residual for changes in expected future cash flows. The Staff recognised that it would be too difficult for insurers to conduct a retrospective estimation of experience adjustments and changes in expected cash flows in each of the prior periods and proposed that insurers are allowed to use the benefit of hindsight 'assuming that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition'.

The IASB agreed that this was a practical simplification. One member asked to remove the guidance suggesting that in the absence of available information the entity could estimate the residual margin by reference to return on equity, saying it was not an appropriate proxy. This was noted by the Staff. The IASB approved unanimously the Staff recommendation.

With regards to the initial application of IFRS 4, the IASB tentatively agreed that the same transitional requirements should apply to IFRS first time adopters.

Lastly, the IASB considered whether re-designation guidance may be required for investment properties and property plant and equipment held by insurer. IAS 40 and IAS 16 allow the option to designate such assets at fair value and allow switching between cost or fair value accounting policies if such change enhances reliability and relevance of financial standards via the application of IAS 8. Therefore the IASB agreed that no additional guidance should be drafted.

Accounting of acquisitions costs incurred before a contract's coverage period (Joint – converged)

The Boards considered four options for recognition of acquisition costs in the pre-coverage period i.e. that acquisition costs were:

1. not recognised until the related coverage begins, and therefore at the start of the coverage period reversing any previously recognised expenses;

2. recognised as an expense when incurred but treating differently the expenses incurred before and after the start of the coverage period;

3. recognised as a prepayment asset, which would then need to be derecognised at the start of the coverage period and treated consistently with other acquisition costs incurred after the start of the coverage period; or

4. recognised when incurred as part of the insurance contract for the portfolio of contracts where the contract will be recognised once the coverage period begins.

The Boards' members considered the fact that insurers presently do not monitor acquisition costs at a contract level and that other decisions for acquisition costs have been made at a portfolio level as a unit of account (limited to successful efforts for FASB). The third option, while theoretically attractive, would have required tracking individual contract's acquisition costs to ensure de-recognition at the start of the coverage period, adding too much preparation cost for little benefit to the users. Therefore the Boards voted unanimously in support of the Staff recommendation for the fourth option. That is to recognise pre-coverage acquisition costs incurred as part of the insurance liability for the portfolio of contracts where the contract will be recognised once the coverage period begins.

This would also be consistent with the Boards previous tentative decisions on acquisition costs incurred on the inception of the insurance coverage.

Decision not to unlock the single margin and diverge from the IFRS approach (FASB)

On 5 September the FASB held a session where they discussed the possibility of unlocking the single margin. No converged decision was achieved on this matter.

The Board members unanimously decided not to unlock the single margin, with changes in actual or expected future cash flows to be reflected immediately in the income statement. If an insurer determines that a portfolio of contracts is onerous, an additional liability should be recognised with a corresponding offset to eliminate any remaining margin. This additional liability should be measured as the present value of future payments for benefits and related settlement and maintenance costs less the present value of future gross premiums less the insurance contract liability already recognised. If the additional liability exceeds the remaining margin, an insurer would recognise an expense for the excess amount. Any write-offs of the single margin on onerous contracts cannot be reversed in the future.

Extract from Deloitte Comment Letter 2010
"The final IFRS should also require that when a portfolio becomes onerous, the insurer must release to profit or loss any remaining aggregate residual margin in full or in part (to the extent needed)."

The IASB re-exposure of its IFRS on Insurance Contracts (IASB)

The IASB meeting on 26 September discussed content and timing of its next milestone document.

The IASB members were faced with a choice whether to publish a revised Staff draft or to re-expose a draft IFRS to public comment. The review draft would have had no set comment deadline and would not have posed any questions, allowing for quicker drafting process of the final IFRS. However, the main concern was whether the significant developments in the IASB's tentative decisions since the ED have been sufficiently exposed to comment to justify publication of the revised draft. The Staff conducted extensive outreach procedures, including field tests and engaging with working groups and have made available for comment a summary of the decisions reached on various topics. Some of the changes from the ED could be seen as clarifications of the principles already articulated or changes made in response to comments.

Four areas were identified by the Staff as significantly modified, and on which targeted questions should be sought in the event of re-exposure. These were accounting for participating contracts, presentation of premiums in the statement of comprehensive income (disaggregation of investment components), unlocking of the residual margin and the 'OCI solution' for discounting.

During the discussions some observed that, given the insurance project has been running for 15 years, the IASB needs to issue the standard as soon as possible. There was a concern that if the re-exposure route is chosen many issues would be challenged again and the project may risk failing altogether. A review draft with extensive outreach was viewed as sufficient due process. Many of the other IASB members had a different view and saw a need for a limited re-exposure with questions focused on the items which have significantly changed since the first exposure draft.

On voting the IASB approved that all the appropriate due process steps have been taken and decided to re-expose the insurance contracts proposals with questions limited to five areas, adding transition to the four topics identified by Staff:

1. participating contracts accounting under the 'mirroring approach';

2. presentation of premiums in the statement of comprehensive income including the disaggregation of investment components;

3. unlocking the residual margin against changes in estimates of future cash flows;

4. the use of Other Comprehensive Income (OCI) for discounting; and

5. transition requirements.

The Chairman, Hans Hoogervorst, emphasised that a limited re-exposure process requires that respondents do not re-open issues which already have been decided and sufficiently deliberated. He asked for the exposure draft to make it clear that the IASB does not seek comments on other issues in this final round of consultations.

Accrual of interest on the residual margin (IASB)

On 26 September, the IASB reconsidered its previous tentative decision to accrete interest on the residual margin resulting in an educational as well as a decision making session on this topic.

The Staff recommended confirming the proposal in the ED that interest should be accreted on the residual margin, to ensure that all parts of the insurance liability are calculated on the same present value basis.

The Staff pointed out that the accretion or non-accretion of interest results in the same cumulative effect in the financial statements but the pattern of reported profit is different. During the education session some IASB members expressed views that accretion, while conceptually justifiable, would unnecessarily complicate the model potentially making insurance less attractive to investors. Some Board members indicated that more complexity resulted from unlocking of the residual margin whilst others felt that accretion is a natural consequence of how the residual margin is calculated.

The discussion was summarised by noting that in the ED the residual margin was just a day one residual but now that the IASB had evolved it into an element of the model connected with the changes in profitability and performance caused by revised estimates of future cash flows thus requiring it also reflects the time value of money. The Staff commented on the concerns of operational difficulties stating that the indication from their outreach activities suggested this can be done at a reasonable cost.

Accretion could not be discussed without considering the rate at which the interest should be accreted. The Staff recommended a locked in rate determined at initial recognition of the contract. Some IASB members thought that using the locked in rate would make the process of interest accretion easier to implement while others questioned its relevance, viewing it as potentially confusing and not representative of an insurer's underlying performance. Some IASB members wanted the measure of the contract to continue to be current with the difference to the 'locked-in' rate reflected in OCI in the same way as for the rest of the insurance liability measurement. However the Staff and other IASB members pointed out that accretion with a locked-in rate provides useful information because it is linked with the insurer's expectations priced at inception. Given future cash flows expectations are always current, a current accretion rate is not necessary.

The IASB approved the Staff recommendations with a majority of ten, for both the accretion and the use of a locked-in rate. Although the FASB is still discussing the issue of accretion, it appeared inclined not to accrete, which would create further divergence between the two Boards.

Extract from Deloitte Comment Letter 2010
"Under our recommended approach of releasing the residual margin over the combined coverage and claims handling period, we do not agree that interest should be accreted on the residual margin. Such accretion would not add any substantial benefit to the relevance of an insurer's financial statements."

IFRS disclosure package (IASB)

The Staff presented a 'package of disclosures' for the Board's approval as a whole. Residual margin, OCI and participating contracts disclosures were not part of the package. The disclosures were first discussed in the educational session where it was noted that the additional reconciliations of aggregate insurance contract liability and insurance contract assets showing the movements in each building block separately was an efficient way of reflecting changes in assumptions. The Board members had minimal discussions on the Staff proposals and approved the package of disclosure proposals presented by the Staff, including requirements that insurers should disclose:

1. gains or losses arising on contract modifications, commutation or derecognition;

2. opening and closing carrying amount reconciliations of insurance contract liabilities and assets, including information about the carrying amounts of onerous contract liabilities recognised in the pre-coverage period; the expected present value of fulfilment cash flows, the risk adjustment and the residual margin; and

3. amounts payable on demand in a way that highlights the relationship between such amounts and the carrying amount of the related contracts.

The IASB tentatively decided not to add more guidance on the level of disaggregation required in presenting reconciliations of carrying amounts. They decided to require only the level of detail necessary to be able to satisfy disclosure requirements and not to obscure the meaning by disclosing information in excessive aggregation or insignificant details.

One of the Staff proposals was around regulatory capital requirements which provoked much debate both in the educational and the decision making sessions. The Staff proposed to disclose the amount of capital the insurer holds to comply with regulatory requirements. The entity would disclose its equity under IFRS and its regulatory capital and restrictions on that regulatory capital determined both at group and individual local jurisdiction levels. The Staff proposal was for an insurer to explain the difference between its IFRS equity and regulatory capital including the effects of those differences. While some thought this would add transparency, others felt that such disclosure was too onerous, industry specific and was going beyond what is required for other financial institutions. The IASB decided not to explore further this proposal.

The IASB also tentatively decided to delete the disclosure proposed in paragraph 89 of the ED about contracts for which uncertainty of the amount and timing of cash flows is not typically resolved within a year.

New converged and complex presentation requirements (Joint – converged)

Preparatory sessions – FASB

In the FASB only meeting held on 3 October, they tentatively decided that an insurer should allocate an amount of consideration to the insurance component for each period, resulting in premium recognised in the statement of comprehensive income, equal to the (implicit or explicit) cost of insurance and other fees charged in the period to the policyholder account balances. This amount may be calculated by deducting from total consideration the amount, if any, allocated to that period to an investment component (and thus excluded from the premium presented in the statement of comprehensive income). The amount of consideration allocated to the investment component for each period may be determinable as follows:

+/- increase (decrease) in the amount of the cash surrender value (or other account balance the policyholder is entitled to through lapse, etc.) for the period

+ the amount of surrenders

+ the cash surrender value included in any death benefits paid

- interest credited to the liability

= consideration allocated to the investment component

This decision was made with a marginal majority of 4 to 3, with the Board stating that it may reconsider this decision at a later date in connection with the decision yet to be made about the premium earned method.

Preparatory sessions – IASB

The IASB discussed on 15 October the papers that would be covered at the joint session on 17 October. These papers explained how insurers should determine amounts for premiums and claims/benefits merely for presentation in the income statement. It also stated that these requirements apply only to contracts accounted for using the building block approach. Staff reviewedthe different presentations considered by IASB and FASB in their June 2012 education session:

- the summarised margin presented in the ED;

- the newly formulated earned premium method;

- the written premium; and

- the premiums due methods of presentation.

The Staff recognised that each of the methods had advantages and disadvantages but on balance the Staff planned to recommend the earned premium presentation method whereby premiums are allocated to periods in proportion to the value of coverage and any other services that the insurer has provided in the period and claims are presented as expenses in the period when incurred. The paper also clarified that this method and the other options do not affect in any way the decisions reached on recognition of profit and they are solely required to populate the income statement with revenue and expense lines from insurance contracts.

Anticipating the outcome of the decision-making session a couple of days later this session displayed no support for the written premium method of presentation.

Similarly the due premium method did not receive positive comments, the main objection being that it would not align with the revenue recognition standard's principles. Some members noted that this approach is currently used by some insurers and is less complex than the earned premium approach and observed that, in most instances, the end result will not differ significantly from the earned premium method.

Despite its acknowledged complexity, the earned premium approach emerged as the best one to meet the presentation criteria in the revenue recognition standard. In particular, the requirement to exclude the investment component from premiums and claims (the disaggregation requirement) received overwhelming support from the IASB. A few members questioned whether this method could be seen as a 'cost plus' approach given that revenue is determined by decomposing the progression of the building blocks unwind towards certainty of outcomes (revenues are essentially the expected outflows adjusted by the experience variances for the period plus the residual margin release for the period). However, it was noted that a 'cost plus' does not take into account the effects of experience adjustments. Unsurprisingly a number of IASB members declared their continued support for the summarised margin approach from the ED and did not feel that the earned premium method will provide any material additional benefit to users of financial statements.

Decisions on presentation of revenue and expenses

The joint session on 17 October considered the different presentation options proposed under the three papers presented in the IASB's 15 October education session.

The first item under paper 2A had a split recommendation from the two Staff teams. IASB Staff recommended that the new standard requires the earned premium presentation "whereby premiums are allocated to periods in proportion to the value of coverage that the insurer has provided in the period, and claims are presented when incurred".

On the other hand, the FASB Staff proposed to use a premium due presentation, "whereby premiums are presented when due and an expense representing the claims, benefits and margins associated with these premiums is presented at the same time".

As expected from the education session held on 15 October, the majority of the IASB was in favour of the IASB Staff recommendation despite acknowledging the complexity of the approach. IASB rationalised their position as a step towards presentation consistency with other industries as well as being a good indicator of performance. Although the preference for the summarised margin approach included in the ED remains across a large minority of IASB members, it will only be kept as a backup plan if no consensus was reached on the earned premium presentation method.

For similar reasons FASB agreed that a premium earned presentation would be preferable to the 'premium due'. The FASB also commented that the premium earned is more consistent with the presentation that would be required under the revenue recognition standard and a better proxy for the volume of activity demanded by users. Supporters of the summarised margin approach could be found also among FASB. Both minority groups accepted that this method does not address the need for volume information that the industry wish to see.

Both Boards voted in favour of using the premium earned presentation (IASB: 13 vs. 2 in favour, FASB: 5 vs. 2 in favour). The FASB asked their Staff to consider the inclusion of application guidance within the new US pronouncement about other approaches that may meet the earned premium principle, noting that the description of the approach within the Agenda Papers was too prescriptive.

Extract from the Deloitte 2010 comment letter

"We believe that the presentation of an insurer's performance would be more relevant if it also included information related to contacts sold in the reporting period.

One possible way to achieve this objective under the current fulfilment value model would be to present the elements of the initial calibration of the residual margin as a separate line at the top of the statement of comprehensive income."

The discussion continued to consider the detailed issues on the mechanics of the earned premium presentation method (Paper 2B) including how to present acquisition costs (Paper 2C).

On the mechanics the key proposals focussed on how to use the estimates of fulfilment cash flows that do not relate to contractual pay-outs for claims and benefits. In these instances the new standard would be to require an insurer to comply with the following:

1. a portion of the premium should be allocated to cover non-claims fulfilment costs (i.e. additional costs that an insurer expects to incur in fulfilling a portfolio of insurance contracts);

2. the premium allocated to cover these costs should be included in insurance contract revenue in the periods in which the costs are expected to be released from the liability of remaining coverage; and

3. the amounts presented as expenses should be the actual costs incurred or added to the liability for incurred claims in the period.

After a short discussion, the IASB voted in favour of this recommendation with 14 members agreeing with the Staff proposal and the FASB agreeing unanimously.

The mechanics for acquisition expenses were dealt with separately because the FASB and IASB had reached different conclusions. Two different proposals were put forward. The IASB Staff recommended that the cash flows relating to acquisition costs be presented in the statement of comprehensive income over the coverage period.

It should be noted that the profit from the contracts does not change from what is determined under the building blocks approach and that this requirement is merely to decompose the building blocks approach liability to present revenue and expenses in the Statement of Comprehensive Income. Unlike all the other items though, an insurer would need to compute the acquisition expense amount to be presented in the income statement and it would need to adjust the release of the residual margin accordingly as the former does not come naturally from the building block approach and the latter is calculated using the actual balance of the residual margin net of acquisition cash flows rather than gross of those amounts.

The IASB approved the Staff recommendation with 14 members voting in favour.

The FASB proposed that acquisition costs be treated as part of the insurance liability and recognised as part of the margin and, either separately presented on the statement of financial position or included in the roll forward as part of the disclosures.

The FASB agreed that the acquisition costs should not be recognised as an asset and that they should be instead deducted from the single margin. Five members of the FASB were in favour of showing the insurance liability in two lines on the financial statements: one for the best estimate and one for the single margin net of acquisition costs.

In conclusion, the Boards unanimously agreed with their Staff proposals that the acquisition costs should be recognised in the Statement of Comprehensive Income in a way that is consistent with the proposed allocation of the residual margin (IASB) / single margin (FASB) thus agreeing to perpetuate in their respective presentation models their divergent decisions reached in terms of the ultimate profit amount recognised for each reporting period. It should be noted though that aside from those stemming from these original differences the debate on the presentation approach did not produce new divergent decisions.

Discount rate in the Premium Allocation Approach (PAA) (Joint – Converged)

Under the Premium Allocation Approach (PAA), the pre-claim liability for remaining coverage is measured initially at the present value of the premiums received and receivable under the contract less acquisition costs. Subsequently, that pre-claim liability is reduced according to the expected timing of incurred claims and benefits. Discounting and interest accretion are required for contracts that have a significant financing component. As a practical expedient, insurers need not apply discounting or interest accretion, if the insurer expects at contract inception that the period between payment by the policyholder of all or substantially all of the premium and the satisfaction of the obligation to provide insurance coverage will be one year or less – a large number of contracts eligible for the PAA are likely to qualify for the practical expedient.

The Staff Paper 2D discussed discounting and interest accretion under the PAA and it addressed the following:

1. whether to use the discount rate at the inception date of the contract or a current rate when discounting and accreting the liability for the remaining coverage;

2. whether the claims and interest expense for the liability for incurred claims should be presented, using the discount rate determined at inception of the contract or the discount rate determined at the date the claim was incurred. Subsequently that rate would be locked–in for presentation in profit and loss;

3. the presentation of the losses and the interest expense for the onerous liability.

Both the IASB and FASB Staff recommended that for the PAA when the liability for remaining coverage is accreted or discounted, the rate that shall be required for its measurement is the discount rate at the inception of the contract. Both the IASB and FASB members voted unanimously to support the Staffs' recommendation of using the discount rate at the inception of the contract. In their decision the Boards considered the limited impact this will have as they expect most contracts would meet the practical expedient offered.

The Staff then asked the Boards to approve the discount rate at which the liability for incurred claims is discounted. The FASB Staff recommended that the claims and interest expense is presented using the discount rate at the inception of the contract and that the rate is subsequently locked in whilst the IASB Staff recommended the use of the discount rate at the date the claim was incurred, and that rate is subsequently locked in.

The majority of FASB members (6 out of 7 present) tentatively supported the recommendation of the FASB Staff to use the discount rate at the inception of the contract as based on their outreach with insurers this method is less complex than using the rate on the date the claim is incurred.

The majority of IASB members, instead, initially supported the IASB Staff recommendation of using the discount rate at the date the claim is incurred since it results in more useful information than the rate at the inception of the contract and that the claims expense is determined using a discount rate that reflects the market conditions at the time.

One IASB member argued that this issue was unlikely to be material to insurers since rates have not shown significant fluctuations during the past few years except for the period during the 2008-09 credit crisis and for that reason, he was in support of the rate at the inception of the contract due to its more limited complexity from an operational perspective.

Following that debate, and in the interest of convergence the IASB Chairman asked for another vote which resulted in the majority of IASB members (13 vs. 2) tentatively approving the use of the rate at the inception of the contract.

The mirroring approach for participating insurance contracts (Joint – Converged)

In their joint meeting on 15 October, the Boards considered previous tentative decisions that apply to contracts with participating features for which the mirroring approach would apply. In particular, the prior tentative decisions on the 'mirroring approach' for participating insurance contracts requiring that an insurer, in order to avoid accounting mismatches, measures and presents the part of the obligation that relates to the underlying items on the same basis as it measures and presents those underlying items.

The IASB decided to achieve this goal by requiring that the measurement of fulfilment cash flows relating to policyholders' participation should be based on the measurement of the underlying items in which the policyholder participates as utilised for the IFRS financial statements. They also decided that presentation of the changes in the 'mirrored' insurance liability would go to profit or loss or other comprehensive income consistently with the presentation of changes in the associated item.

The FASB decided to implement the 'mirroring approach' in a different way by limiting it to liability for performance-linked participation contracts and by requiring that an insurer measures these contractual obligation using the building blocks approach adjusted to eliminate accounting mismatches that reflect timing differences between the contractual obligation and the measurement of the underlying items in the statement of financial position and that are expected to reverse within the boundary of the insurance contract. Like the IASB, they also required that changes in the liability should be presented in the same way in statement of comprehensive income as the underlying item. The FASB definition of performance-linked participation contracts has not been defined but we expect it to lead to a narrower set of contracts than that considered in the IASB decision.

Both Boards had also agreed in the past that the discount rate for cash flows arising from participating contracts should reflect the dependence of those cash flows on the performance of those assets and that those cash flows include both guaranteed and discretionary elements arising from current contracts regardless of whether paid to current or future policyholders.

Due to the difference noted above, there are situations where in accordance with the IASB's tentative decisions, the 'mirroring approach' would be required and that would not be true under the FASB's tentative decisions. Insurers will need to be aware of these instances and account for them accordingly as described in the paper.

The IASB Staff asked the Boards whether further clarification would be required of how changes in the insurance liability (including the effect of changes in discount rate) would be presented in comprehensive income when the 'mirroring approach' applies. Both the IASB and FASB members voted unanimously that no further clarification was required.

However, some members noted that the drafting of the text needs to be specific to note that the 'mirroring approach' will take precedence over all other approaches including the 'OCI solution'.

The FASB was asked to decide the accounting treatment where the 'mirroring approach' does not apply under their narrower definition and to confirm that, in that case, changes in the discount rates should be presented to profit and loss if the underlying items on which participation is based are recorded at fair value through profit and loss. The FASB members voted unanimously in favour of this Staff recommendation.

Financial Instruments with Discretionary Participation Features (IASB)

In its February 2012 meeting the IASB reconfirmed the ED proposal to keep financial instruments with discretionary participating features (DPF) in the scope of IFRS 4, but restricting it only to those issued by an insurer. FASB on the other hand tentatively decided to include them within the scope of their financial instruments standard.

In the IASB only session held on 19 October, the IASB decided to use the draft words in Paper 10A referring to participating insurance contracts and to adapt them to financial instruments with DPF. The main area that needed clarification was the contract boundary. The IASB had tentatively re-defined the contract boundary for insurance contract as "the point at which the contract no longer confers substantive rights on the policyholder". Applying the same main principle to financial instruments with DPF the Staff firstly proposed that the contract boundary for a financial instrument with a discretionary participation feature is the point at which the contract no longer confers substantive rights on the contract holder. This occurs when:

- the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract; or

- the premiums charged confer upon the contract holder substantially the same benefits as those that are available, on the same terms, to those that are not yet contract holders.

Secondly, the Staff proposed that the recognition of a financial instrument with DPF "when, and only when the entity becomes party to the contractual provisions of the instrument", using the words of IFRS 9:3.1.1.

The IASB members clarified that this would be consistent with the post-ED decision to recognise insurance contracts from the beginning of coverage (i.e. when the contract begins), rather than from the date the insurance contract was signed as was proposed in ED.

As the Staff confirmed that this was the case the IASB approved the Staff recommendation unanimously.

The IASB also considered whether any further modifications were necessary to adapt for financial instruments with DPF, in particular surrounding the allocation of the residual margin. The Staff proposed not to make any further modifications. In particular, the tentative post-ED decision to release the residual margin to profit or loss in a way that best reflects the pattern of services provided should apply equally to the financial instruments with DPF without the need for any specific guidance. During the discussion some IASB members noted that the ED guidance referring to the margin being released based on the fair value of assets under management was potentially confusing as to when and how to apply it and welcomed its removal. Similarly, the Staff paper proposed not to make any changes to the guidance on unbundling as the unbundling of distinct investment components and exclusion of non-distinct investment components from volume information should apply to the financial instruments with DPF in a similar way as it does to insurance contracts with DPF.

The IASB members agreed unanimously with the Staff analysis.

Next steps

At the time of writing, joint meetings are taking place during the week commencing 19 November.

The main topics that are being deliberated include the discount rate to apply to contracts that are affected by expected asset returns, but which are unaffected by the mirroring decisions. Examples of such contracts include universal life and index-linked contracts.

In addition, the IASB will discuss the presentation and disclosures of insurance contracts. The IASB is also discussing the staff proposal for the fieldwork that they intend to undertake after publishing the revised Exposure Draft.

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