

Insurance Spotlight

October Roundtable and Joint Meeting Highlights

In This Issue:

- Deloitte Roundtable Discussion
- Updates From the Joint Meeting and the Insurance Working Group
- Thinking Ahead



The Bottom Line

Deloitte hosted the 11th event in the Insurance IFRS Roundtable series to discuss significant developments related to the boards' insurance contracts project.

- Deloitte's insurance practice hosted the 11th event in its Insurance IFRS Roundtable series to discuss significant developments related to the FASB's and IASB's (the "boards'") insurance contracts project as well as the financial instruments project and the much-anticipated SEC announcement on whether and how to incorporate IFRSs into the U.S. GAAP financial reporting system.
- The series continues to attract a diverse group of executives from some of the largest insurance companies. Participants have represented a cross-section of business lines, including property and casualty, life, and health insurance. Group members expressed interest in understanding the implications of the tentative conclusions the boards reached over the last quarter, and particularly over the past month, during which the FASB has indicated a preference for what is arguably a two-model approach.
- Deloitte's Actuarial, Risk & Analytics Practice delivered a presentation on the margin models for both short- and long-duration contracts that highlighted not only the complexities in the mechanics of the margin approach but also the significant changes in profit emergence relative to current practice under U.S. GAAP and under the boards' respective proposals.
- Roundtable participants had mixed reactions about the project's status and the lack of agreement not only among the boards but also among each board itself and among staff and individual board members. Some participants raised concerns and expressed frustration about the impact that such disagreement has had on the project's progress (or lack thereof) and on tentative decisions reached.
- Dissent was also evidenced at the joint board meeting in Norwalk on October 20, at which many past discussions were relived and the debate was resumed over whether there should be a one-model or two-model approach to liability measurement.

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Beyond the Bottom Line

On October 4, 2011, Deloitte's Insurance Practice hosted an Insurance IFRS Roundtable in New York City. At this invitation-only event, attendees from many of the largest insurance companies discussed the insurance contracts project, networked with each other and with Deloitte Insurance leaders, and exchanged views on the future of insurance accounting.

This *Insurance Spotlight* summarizes Deloitte's October Insurance IFRS Roundtable, including highlights from the formal presentation on the status of the insurance contracts project, the associated commentary, and participant discussions as well as developments from the most recent joint meeting held in the United States on October 20 and the Insurance Working Group session on October 24.

Deloitte Roundtable Discussion

In the months of redeliberations since issuance of the FASB's discussion paper (DP) and the IASB's exposure draft (ED) on insurance contracts, the boards have made numerous tentative changes to their proposed guidance. Deloitte's quarterly roundtable series offers insights into each key decision reached and seeks to foster industry discussion as the two boards work to finalize the insurance contracts project.

Significantly Delayed and Uncertain Timetable

After revisiting their technical plan multiple times, the boards revised the insurance contracts project plan twice in September and are now hoping to align issuance of the FASB's DP with reexposure of the IASB's ED or issuance of a review draft in the first half of 2012. Accordingly, publication of a final standard is likely to be moved beyond calendar year 2012, and the boards are being pressured to revise the effective date to beyond January 1, 2015. Although other projects, including financial instruments, revenue recognition, and leases, have been similarly delayed, in the absence of a detailed work plan, next steps and the ultimate timing remain uncertain.

In discussions on the interplay between the financial instruments project and the insurance contracts project, industry participants expressed strong views that the effective dates for these standards should be aligned.

Arguably the most positive impact of delay in the insurance contracts project is the alignment of the boards' timetables.

Divergence on Accounting for Risk and Profit

Deloitte leaders led the roundtable discussion by reviewing the boards' divergent positions and discussing how constituent preferences for either the FASB's composite margin (single margin) or the IASB's risk adjustment (two margin) approach appear to be divided along geographical lines. It was noted that each model fulfills its own distinct purpose and that these differences could be an obstacle to achieving full convergence.

Quarterly developments on profit recognition included the IASB's tentative decision, approved by a narrow 8 to 7 margin, that the residual margin should not be locked in at inception but instead unlocked prospectively for changes in estimates. This decision was made despite concerns raised by the large minority of the IASB, and shared by the FASB, that such a recalibration could create additional issues for an already complex measurement model and further impair transparency.

This tentative decision indicates the potential for reassessment of the purpose of the residual margin and raises concerns that the insurance contracts project is becoming an "unearned profit" model focused more on revenue recognition than liability measurement.

The group also discussed the FASB's preference for what is arguably a two-model approach, noting that the FASB voted against its staff's recommendations and tentatively decided that certain contracts (typically those that are considered short duration under

The FASB decision on the premium-allocation approach increases the focus on developing a comprehensive set of eligibility criteria.

current U.S. GAAP) should use the unearned premium method during the coverage period with a two-building-block liability approach for the post-claim cash flows. Under this method, companies accounting for these contracts that qualify for the premium allocation approach would essentially use current U.S. GAAP modified to reflect the statistical mean (building block 1) and discounted for the time value of money (building block 2), if material.

This FASB decision, and the underlying debate on whether the premium-allocation approach represents a separate model or a proxy to the original fulfillment-based measurement model that uses the “building block” approach, increases the focus on developing a comprehensive set of eligibility criteria that delivers a relevant and reliable basis for separating this subset of insurance contracts.

The FASB also reached tentative decisions on subsequent recognition of the single margin for contracts measured under the building block approach, thus confirming the staff’s recommendation that companies earn the composite margin as the underlying uncertainty of the probability weighted cash flows is reduced. This reduction in variability in cash flows, or release of risk, is achieved primarily because of the passage of time for life contracts or as more information becomes known about the frequency and severity of the insured event for nonlife contracts.

Although the boards made progress earlier this year to align their views on acquisition costs and tentatively agreed that only direct acquisition costs should be included in the fulfillment cash flows, divergence remains on whether costs associated with unsuccessful efforts should be included in the final standard; the FASB’s current position is to limit such costs to successful efforts.

Development for Participating Contracts

The IASB tentatively concluded that for contracts in which cash flows are contractually linked to the items held within a participating fund, the cash flows should be included in the liability on the same basis as the measurement of the underlying items in which the liability participates. Further, the measurement should take into account any asymmetric risk sharing arising from minimum guarantees, with changes in the liability reflected in the statement of comprehensive income (the income statement) on the same basis as the changes in the underlying items.

The boards’ reached agreement on the project’s axioms, the first of which states that an “ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.” However, despite the boards’ agreement, the FASB continues to prefer an approach in which companies fully measure the liability by using the building block approach. The FASB acknowledges this may lead to some accounting mismatch.

Accounting for Reinsurance

Roundtable participants commented on tentative reinsurance decisions reached earlier this year that significantly changed guidance in the original proposals. One such decision, which reversed the original proposals’ position about the treatment of day-one gains, generated interest and debate among participants. Deloitte leaders remarked that companies would no longer be able to recognize day-one gains and noted that such gains would effectively be deferred under the margin approach. Losses would also be deferred, except when the reinsurance was considered retrospective; in such cases, a day one-loss should be recognized immediately.

In addition, the discussion focused on the boards’ decision to move away from the expected loss model originally proposed in connection with cedants’ accounting for reinsurance assets. The FASB favored an event-driven analysis and consideration of the credit risk of the reinsurer, and the IASB preferred an impairment model similar to that outlined in the financial instruments project redeliberations.

The tentative decisions reached on the topic of reinsurance are more in line with current U.S. GAAP accounting for reinsurance and are likely to be revisited as the boards make progress on other facets of the project on which reinsurance decisions are interdependent.

Presentation and Disclosure

Regarding presentation, it was noted that the boards conceptually agree that premium and loss information is important to certain users of the financial statements. The boards' compromise resulted in a two-section approach to the income statement that would provide premium and claim information for contracts that qualify for the premium-allocation approach and margins for contracts measured under the building block approach.

Recommendations regarding the proposed disclosure requirements included (1) deleting the requirement that indicated an insurer should not aggregate any information arising from differing operating segments and (2) revising the principle to state that information that is useful should "not [be] obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics."

Additional details on presentation were discussed by the boards after the roundtable discussion. See the "Updates From the Joint Meeting and the Insurance Working Group" section below for more information.

Modeling Approaches

Deloitte's Actuarial, Risk & Analytics practice wrapped up the roundtable discussion by highlighting the differences in the FASB and IASB models under (1) current U.S. GAAP, (2) the original proposals in the DP and ED, and (3) tentative decisions reached by the boards for both short-duration and other-than-short-duration contracts. The modeling exercises focused the group on the complexities of the approaches and highlighted the changes in profit emergence that would result from the liability measurement.

The modeling, which used simplified contracts and assumptions, tangibly illustrated the differences in liability measurement and profit emergence under the differing views and resulted in significant questions being raised about the ability of the boards to reconcile the different approaches through disclosure.

Updates From the Joint Meeting and the Insurance Working Group

Despite six hours of discussion at their October 20 meeting, which began an hour earlier and ran an hour longer than scheduled and included various attempts to reach agreement, the boards made only limited progress on their staffs' broad recommendations for presentation requirements. The boards continue to disagree about whether the premium-allocation approach represents a proxy to the building blocks approach or a separate measurement model and, accordingly, how the revenues and liabilities from each should be presented. In addition, unsettled debates resurfaced in connection with unbundling and deferred acquisition costs. The boards discussed the impact that previous decisions have had, and that future decisions could have, on presentation. The discussion culminated in the boards' request to send the staff back to research the possibility of separating the deferred acquisition costs embedded in the cash flows of liability for presentation only in what could now come full circle and result in a separately reported asset in the statement of financial position.

The boards were able to reach some tentative decisions on characteristics that would qualify for scope exclusion for fixed fee contracts and agreed with the "spirit" of the recommendation made by the staff on the premium-allocation approach eligibility criteria, which would be made on a contract-by-contract basis. No decisions were reached regarding the eligibility criteria, however, because there were significant concerns about

A lengthy recent meeting underscored the fundamental philosophical differences that remain in the boards' approaches.

the words drafted and whether they would be interpreted appropriately as written, especially given the significance of the eligibility criteria to the proposed accounting model(s).

The next joint meeting on insurance contracts is scheduled for the week of November 14.

In addition, on October 24, the IASB-established Insurance Working Group (IWG)¹ met in London to discuss industry perspectives on key elements of the project. The most notable item of this discussion centered on the potential for accounting mismatch and short-term volatility in assets and liabilities that have been raised continually and currently have the potential to obscure long-term business performance. The IWG conceded that the measurement through the income statement for participating contracts was indeed reflective of the economics of the contracts, but presented alternatives regarding the need for an other-comprehensive-income (OCI) option for certain movements in the liability. Although a majority of the IWG members expressed support for an option to use OCI for movement in certain assets and liabilities, it was noted that such approach would need to be defined explicitly for certain types of broad contracts so as to avoid an “OCI free-for-all.” The IASB staff has agreed to consider the options presented for further analysis by the boards.

Thinking Ahead

A decision about whether and, if so, how to incorporate IFRSs into the U.S. financial reporting system has yet to be made by the SEC. Early indications and comment letters received by the SEC seem to suggest the likelihood of an “endorsement” model with a “big bang” approach to adoption rather than a staggered approach, which many fear would prolong the process and disrupt financial reporting. Regardless of decisions reached on this front, the boards acknowledge that they still have significant work to do to align key aspects of the insurance contracts project, including those related to scope and measurement, reinsurance accounting, presentation and disclosure, and ultimately transition and effective date.

A decision about whether and, if so, how to incorporate IFRSs into the U.S. financial reporting system has yet to be made, but the SEC is poised to take center stage in the coming months.

Arguably the most positive impact of delay in the insurance contracts project is the alignment of the boards’ timetables. With the impending reexposure of the financial instruments, revenue, and leases EDs, it is likely insurance contracts will suffer the same fate, particularly if the boards are unable to reach agreement on certain key provisions.

Insurance companies and entities that issue insurance contracts should continue to:

- Monitor the project’s status and exchange views with others in the industry to better assess the ramifications of tentative board decisions on the financial accounting and reporting processes.
- Actively participate in discussions with the boards and their staffs and in public forums to ensure that their voices are heard by the standard setters.
- Evaluate the ability of existing data systems and processes to capture the information needed for compliance with proposed accounting and disclosure requirements and assess the impact on current business practices.

Watch for additional publications on the insurance contracts standard as we continue to explore the practical and business implications of the decisions reached by the boards.

Other Deloitte Resources

- [October 26, 2011, IFRS Project Insights: Insurance Contracts.](#)
- [September 2011, Insurance Spotlight, “Insurance Contracts — A Look at the Current State of the Convergence Project.”](#)

¹ The IWG reflects the interests of a wide range of parties, including senior financial executives involved in financial reporting, who meet to analyze accounting issues related to insurance contracts.

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