During their May 2012 joint meeting, the International Accounting Standards Board and the Financial Accounting Standards Board (respectively, the IASB and the FASB, or collectively, the Boards) re-deliberated decisions in the IASB's Exposure Draft Insurance Contracts (ED) and in the FASB's Discussion Paper, Preliminary Views on Insurance Contracts (DP). The following topics were discussed:

1. The use of OCI to present certain changes in the insurance contract liability
2. Unbundling of investment components from insurance contracts
3. Recognition and presentation of acquisition costs

The IASB held a separate session to consider whether it should revisit some of its earlier margin decisions. All of the decisions noted here are tentative and may change as the Boards have not yet concluded their deliberations.

Financial Instruments

The IASB and the FASB continue to work together to resolve key differences between the classification and measurement model in IFRS 9 Financial Instruments and the model the FASB is developing. At the May meeting, the IASB tentatively decided that a Fair Value through Other Comprehensive Income (FVOCI) measurement category would be added to IFRS 9 for debt instruments that pass the contractual cash flow characteristics assessment. This would further align guidance in IFRS 9 with the FASB's tentative model. The FVOCI category would be subject to the same impairment and income recognition models as those financial assets that are measured at amortised cost. Cumulative fair value gains and losses recognised in OCI would be recycled to profit or loss upon de-recognition.

The Boards also tentatively agreed to align their business model assessment for the FVOCI category of financial assets that meet the cash flow characteristics criteria, and their requirements on reclassifications of financial assets between measurement categories.

The FASB and IASB decided to have changes in insurance liabilities arising from fluctuating interest rates presented in OCI. This is linked to their decision on the Financial Instrument projects, where they introduce a fair value through other comprehensive income (FVOCI) approach for certain debt instruments.

The Boards decided to measure distinct investment components of insurance contracts as financial instruments.

The IASB reaffirmed the decision to include a separate risk adjustment in its model; and noted that the residual margin will be adjusted for changes in estimates of future cash flows.

The Board materials for this meeting are IASB/FASB Agenda Papers 2-2M and 14-14C, and the IASB Update and the FASB Summary of Decisions.
As illustrated in the chart, debt instruments (such as loans and debt securities) would be classified (based on their contractual characteristics and business model within which they are held) into one of the following three measurement categories: amortised cost, FVOCI or Fair Value through Profit or Loss (FVTPL).

The Boards have yet to address whether to introduce an option for financial assets that meet the business model criteria for FVOCI to be recorded at fair value through profit or loss. They intend to issue their respective exposure drafts on classification and measurement in the second half of 2012.

We discuss the impact for financial instruments accounting in more detail in our IFRS Developments Issue 31 Financial Instruments: Classification and measurement – the GAAP differences continue to narrow.

Use of OCI for changes in insurance liabilities

The Boards previously held a number of educational sessions to discuss the possibility of using OCI for limited changes in insurance liabilities. At these meetings, the staff asked the Boards to decide on several issues regarding the use of OCI to present changes in insurance liabilities that result from movements in discount rates.

The staff explained the three core objectives of introducing such an OCI approach:

- Achieving transparency around an insurer’s core results, particularly by providing a useful interpretation of both underwriting and investment results
- Reducing income statement accounting mismatches if assets are held at FVOCI or amortised cost

While the staff acknowledged that the ED/DP approach to recognise changes in discount rates in profit or loss has significant advantages, they believe that the use of OCI for those changes would result in more useful information. Therefore, they recommended that the Boards adopt its use.

Board members debated arguments for and against the use of OCI. Those in favour believed it would result in transparent reporting of performance that is in line with the Boards’ decision to apply a FVOCI category for financial assets. Opponents argued that the proposed OCI approach would fail short of its objectives and expressed concern about the complexity and the potential lack of comparability in this approach. Following a lengthy discussion, all seven members of the FASB and 10 of 14 IASB members voted in favour of adopting the use of OCI for changes in the discount rate. The Boards further decided, albeit with smaller majorities, that insurers would be required to use OCI to recognise those changes for all insurance liabilities, except participating contracts (i.e., those contracts linked to the performance of specified assets). For those contracts, the Boards will consider how this OCI approach should be applied at a future meeting.

There was also discussion as to whether any other components of the change in liability should be reported in OCI. The staff noted that some have argued that changes in interest-sensitive cash flow assumptions should be presented in OCI because it would be inconsistent and difficult to separate them from discount rate changes. The Boards were not persuaded. They concluded that, even though cash flow assumptions are related to discount rates, it would be important to treat them consistently.
After deciding to adopt an OCI approach, the Boards reviewed the details, and agreed that the cumulative amount reported in OCI is the difference between the liability calculations for the contracts in-force at the reporting date based on:

a) The discount rate determined at inception

And

b) The current discount rate on that date

Under this approach, the interest expense recorded in profit or loss for interest accretion to the insurance liability is determined through the discount rate locked in at inception. Furthermore, upon de-recognition of (or a part of) the insurance liability, any related amounts should be recycled from accumulated OCI. To reduce the complexity, the Boards also clarified that this locked-in rate should be used to determine the re-measurement effect of changes in expected cash flows that are absorbed by the residual margin (IASB) or reported in profit or loss (FASB).

Finally, the Boards decided not to introduce a loss recognition test. One member thought a useful representation of retained earnings would necessitate a loss recognition test. However, a clear majority of the Boards were opposed, noting other issues such as the need to determine an appropriate asset rate.

How we see it

The Boards’ conclusion to require all changes in discount rates to be presented in OCI appears to be aligned with their decision to introduce a FVOCI category for financial assets. Nevertheless, some financial instruments backing insurance liabilities would not be measured at FVOCI, such as derivative instruments and some equity securities. Moreover, this proposal would prevent insurers from applying current measurements to both assets and liabilities with changes in estimates recorded in profit or loss.

The decision not to introduce a loss recognition test will affect performance reported in profit or loss during the life of the contract under certain circumstances. If market interest rates decline over time, the investment yields the insurer expects to earn on the assets may also decrease, e.g., due to lower reinvestment rates. However, without a loss recognition test, the income statement liability discount rate is not ‘reset’ and the re-measurement of insurance liabilities will result in a lower discount rate in OCI. As a result, future profit or loss will be negatively impacted through declining asset returns versus an interest accretion expense on the insurance liabilities at the original locked-in rate.

Unbundling of investment components from the insurance contract

In a previous meeting, the Boards defined investment components in an insurance contract as amounts the insurer is obligated to pay regardless of whether an insured event occurs. Additionally, the amounts should be presented separately in the statement of financial position. The discussion in May focused on when investment components should be separated and measured separately as a financial instrument, i.e., unbundled, rather than as part of the total insurance contract liability. The staff relied on the Boards’ previous decision on unbundling goods and services within an insurance contract as a basis for their proposal; they generally agreed with the recommendation, but with several modifications.

Specifically, the Boards decided to unbundle only distinct investment components of insurance contracts. An investment component would be distinct if that component and the insurance component are not highly interrelated. They also agreed that the following indicators would imply those components are highly interrelated:

1. If one of the components lapses or matures the other component also lapsing or maturing
2. The investment component is not available as a standalone product in the same market or jurisdiction
3. The value of the insurance component is dependent on the value of the investment component or vice versa.

2 IFRS 9 already includes an OCI measurement option for equity instruments which are not held for trading. Under this irrevocable option, only dividends are recorded in profit or loss. No ‘recycling’ of gains and losses is permitted.
Any investment component determined to be distinct should be measured under the appropriate accounting guidance for financial instruments.

The Boards confirmed previous decisions to unbundle embedded derivatives (when not closely related (IASB), or not clearly and closely related (FASB), to the insurance component) and non-insurance goods and services (when the performance obligation to provide the goods or services is distinct). They also reiterated their intention to exclude an amount for (non-distinct) investment components from the premium presented in the statement of comprehensive income; and will continue their debate on disaggregation of premiums at a future meeting.

Discussions continued about whether insurers should be permitted to unbundle components if they were not required to be unbundled. To maintain comparability, the Boards decided not to permit insurers to unbundle any component where unbundling was not required.

### Acquisition costs

The Boards held a joint education session to consider how to account for cash flows relating to the recovery of acquisition costs under the Building Block Approach (BBA) and the Premium Allocation Approach (PAA), and resolve how to present the information about those cash flows.

For the BBA, the staff presented three alternative approaches:

1. One that recognises the right to recover acquisition costs as an asset, subject to amortisation.
2. Another which includes acquisition costs in the cash flows used to determine the margin, requiring the insurer to recognise a reduction of the residual/single margin when the acquisition costs are incurred with no effect on profit and loss. The acquisition costs would be shown net against the residual/single margin and allocated to profit and loss in the same way as the residual/single margin. Changes in the insurance contract liability arising from acquisition costs would be shown with the release of margin and not as a change in the cash flow.
3. A third option which includes the acquisition costs in the cash flows to determine the margin and requires the insurer to expense acquisition costs and recognise income equal to, and offsetting, those costs when incurred. Changes in the insurance contract liability arising from acquisition costs would be shown in the same way as the changes in cash flows.

The staff explained that while alternatives 2 and 3 above show different amounts on individual line items in profit or loss, they should both produce the same net result. Presumably, the same will be true for alternative 1 if the amortisation pattern for the asset is consistent with the release pattern of the residual margin under alternatives 2 and 3.

Board members had different views on the approaches. The IASB confirmed that acquisition costs should be treated as part of the contract cash flows and not recognised as a separate asset. Furthermore, they expressed a comfort level with having the staff explore either alternatives 2 or 3. However, the FASB noted that they could not support an alternative that recognises revenue to offset amounts recognised as acquisition costs (alternative 3).

The Boards concluded that a future decision on acquisition costs will need to link to their discussion of income statement presentation, including how to account premiums earned under the BBA. They also noted that their decision would need to be evaluated against the treatment of acquisition costs selected for the PAA. No decisions were reached at this meeting and the topic of acquisition costs will be revisited in the future.

### How we see it

In re-deliberating the ED/DP, the Boards explored guidance for unbundling investment components based on the Revenue Recognition proposal, rather than a wide range of contracts. Since the unbundling guidance for investment components is similar to the concepts considered during previous discussions, it is likely the Boards will continue to take a narrow unbundling approach. However, a fairly narrow unbundling of investment components could mean the Boards prefer to pursue a broader disaggregation of investment components for income statement presentation.

Each of the Boards clearly indicated their preferences. The IASB rejected alternative 1 (to recognise as a separate asset), preferring alternative 3 (to recognise income to offset incurred acquisition costs). The FASB could not accept alternative 3 and expressed a preference for alternative 1. As indicated by some Board members during the meeting, exploring alternative 2 (acquisition costs shown net against the residual/single margin) and comparing it with the proposed alternatives for the PAA might provide the Boards with an agreeable solution, assuming they are willing to compromise.
Margins (IASB only)

At the April meeting, the IASB and the FASB held an educational session to discuss the single margin model tentatively adopted by the FASB. In May, the IASB reviewed whether it should consider reversing its current tentative decisions on risk and residual margins.

The IASB discussed whether to stay with a separate risk and residual margin (two margin approach) or consider changing to a single margin approach. Those who were not in favour of a separate risk adjustment (and taking the changes in the risk adjustment to the profit and loss) argued that it was subjective because of the use of entity-specific risk estimation techniques. Those in favour argued that, while they acknowledge the simplicity of the single margin, it did not allow for subjectivity, and that IASB members would still have to consider the release of the single margin. After the exchange of the pros and cons, the IASB decided to retain the two margin model.

As part of this discussion, the IASB considered investigating whether the residual margin could be adjusted for re-measurement of the risk adjustment; some members viewed this as a means of alleviating concerns about the subjective nature of risk adjustments. However, the IASB also decided to maintain its decision to only unlock for changes in estimates of future cash flows, and not to explore whether other changes in estimates should be offset in the residual margin.

How we see it

With the IASB confirming a two margin approach and deciding not to explore alternatives, it is unlikely that the Boards will converge on margins before issuing their next documents on the insurance contracts project. In fact, a recent report by the IASB Chair to the Trustees noted that the Boards are working on separate documents, so this decision by the IASB is not surprising.

A decision not to explore alternative margin approaches could indicate that the IASB is willing to proceed with the project and not incur further delay by re-opening issues.

Next steps

The IASB plans to issue a revised exposure draft or a review draft of the final standard in the second half of 2012. It will establish a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the same period.

The Boards will have their next discussion on insurance during the June Board meetings, where they will discuss how to separate components of an insurance contract and possible models for determining earned premiums under the BBA. Further, the IASB will hold its next Insurance Working Group meeting on 25 and 26 June.

Boards review OCI, unbundling investment components and recognition of acquisition costs
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