

ACCOUNTING UPDATE

CAGNY

June 2, 2009

Willis

© Stanhope by Hufton + Crow

AGENDA

- Accounting System Convergence
- IASB Insurance Contracts Project
- Mark-to-Market Accounting

ACCOUNTING SYSTEM CONVERGENCE



WHERE ARE WE TODAY

- At least three separate accounting systems:
 - U.S. GAAP Accounting
 - U.S. Statutory Accounting
 - IFRS (“International Financial Reporting Standards”)
- IFRS permits the use of “Country GAAP” until standards are finalized

WHERE ARE WE HEADED?

- IFRS only?
- To understand where we're headed, we need to go into a little history
 - The different accounting systems
 - Their recent history



U.S. GAAP

- Long established
- Promulgated by the Financial Accounting Standards Board (“FASB”)
- Influenced by the SEC – used for SEC filings
- The accounting system used by almost all U.S. corporations, including many insurance companies



U.S. GAAP

- GAAP “Hierarchy” – pronouncements – “Statements of Financial Accounting Standards” issued on individual topics & revised or replaced as needed
- Seen as “rules based” vs. “principles based”, especially in the wake of Enron
 - FAS 133 - *Accounting for Derivative Instruments and Hedging Activities* – 176 pages
 - FAS 141 – *Business Combinations* – 358 pages

U.S. STATUTORY ACCOUNTING



- Long established
- Promulgated by the NAIC
- Based on GAAP – was “codified” in the late 90’s to mimic GAAP’s Hierarchy
 - SSAP’s – Statements of Statutory Accounting Principles

U.S. STATUTORY ACCOUNTING



- Basis for insurance company regulation
- Significant modifications aimed at conservatism
- Primary Goal – assess claims paying ability

IFRS



- Promulgated by the International Accounting Standards Board (“IASB”)
- Relatively new
 - 2001 - IASB formed
 - 2002 - EU passes regulation to adopt IFRS
 - 2003 - First standard (IFRS 1) issued
 - 2003 - Australia, New Zealand and Hong Kong decide to adopt IFRS
 - 2005 – In effect in EU

IFRS



- Inspired by GAAP but intended to be more principles based
- Intended to replace sometimes widely divergent “country GAAPs” which themselves borrowed from U.S. GAAP

IFRS



- Rolling Implementation
- New standards are first issued as “Discussion Papers”
- After public comment the standard, with any changes, is issued as an “Exposure Draft”
- After a final round of comments the standard is issued as a published IFRS and adopted

IFRS



- Until an IFRS standard on a specific topic is adopted individual “country GAAP” is used
- As of right now, IFRS is not uniform
 - Insurance standard not finalized so a UK insurer is using a different accounting basis than a Swiss insurer

CONVERGENCE

- FASB and the IASB have had a longstanding commitment to working together
 - 2002 – “compatibility”
 - 2006 – “convergence”
- Identify “best practices”
- Reduce compliance burden for multi-national companies
- The two Boards have worked on a number of joint projects both “big picture” and industry specific

JOINT PROJECTS

- *Conceptual Framework for Financial Reporting*
 - Intended to define the elements of “decision useful” financial statements
 - Essential Characteristics
 - Relevance & faithful presentation
 - Enhancing Characteristics
 - Comparability, verifiability, timeliness & understandability
 - Pervasive Constraints
 - Materiality & cost

JOINT PROJECTS

- *Financial Statement Presentation*
 - Intended to converge how financial performance is reported in financial statements
 - How information is aggregated, disaggregated or totaled
 - Whether there should be such a thing as “Other Comprehensive Income” and when it should be cycled through income
 - Interim reporting
- Many others, including *Insurance Contracts*

RECENT TIMELINE

- November, 2007 – The SEC eliminates the GAAP reconciliation requirement for non-U.S. registrants
- April 2008 – The SEC raises the idea of moving to IFRS
- August, 2008 – The SEC formally proposes a “roadmap” for adopting IFRS in the U.S.
- November, 2008 – Roadmap released
- April, 2009 – deadline for comments

IFRS ADOPTION



SEC ROADMAP - WHAT

- A 165 page document that specifies the timeline and conditions for the adoption of IFRS by SEC registrants
- Adoption is contingent on IFRS meeting certain requirements
- Final decision will be made in 2011
- Further rulemaking would be required before IFRS is mandated

SEC ROADMAP - WHAT

- Milestones

- Improvements in IFRS accounting standards
- Accountability and funding of IASC Foundation
- Improvement in XBRL reporting
- Education and training

- Main ones are fairly subjective

SEC ROADMAP - WHY

- Global nature of capital markets
- Use of a single, widely accepted set of high-quality accounting standards would improve comparability and benefit U.S. investors
 - Cited the large percentage of U.S. persons who invest in foreign companies
- 113 countries require or permit IFRS reporting
- Current IFRS participants – the EU, Australia and Israel represent 26% of global market capitalization
 - Would rise to 31% when Canada and Brazil adopt

SEC ROADMAP - WHEN

- Allows certain companies to adopt IFRS as early as CY 2009
- Would require mandatory adoption by large accelerated filers as early as CY 2014
- Would require mandatory adoption by remaining accelerated filers as early as CY 2015
- Would require mandatory adoption by all SEC registrants by CY 2016

SEC ROADMAP - WHEN

- Early adoption focused on situations where using IFRS would promote comparability with competitors
 - Industry must be an “IFRS industry”
 - IFRS must be used more than any other system by the top 20 companies within that industry
 - U.S. early adopter must be in the top 20
- Reporting and reconciliation issues – comparative years – IFRS or GAAP
- What happens if adoption is delayed or cancelled?

INITIAL REACTION



INITIAL REACTION

- FASB seemed to think of this as a done deal
 - Contemplated their future role as an office of the IASB
- As the prior “convergence” plan became a replacement plan it caused many U.S. companies to examine IFRS proposals more closely
- So, is GAAP dead?

SEC ROADBLOCKS

- Not necessarily
 - The new administration
 - The ongoing financial crisis

SEC ROADBLOCKS

- Mary Shapiro – new SEC Chair
 - The SEC won't be bound by the prior administration's agreements on the Roadmap and convergence
 - Not convinced that IFRS is an improvement over GAAP
 - Concerned about cost of conversion and aggressiveness of the timetable

SEC ROADBLOCKS

■ The Financial Crisis

- To a certain extent, Congress views SEC accounting as an instrument of policy
 - SOX
 - Mark to market accounting
- Adoption of IFRS, administered by the IASB, would greatly diminish the Congress' ability to influence accounting policy directly through the SEC or indirectly through FASB

STATUTORY ACCOUNTING OPTIONS

- Statutory Accounting is based on GAAP
 - Has adopted the GAAP “framework”
 - Incorporates GAAP pronouncements, often with modification, as guidance within its hierarchy
 - Ongoing GAAP pronouncements are considered for adoption
- What happens if the U.S. adopts IFRS?

STATUTORY ACCOUNTING OPTIONS

- The NAIC could “freeze” statutory accounting in its current state
 - May lead to an increasing disparity between the two systems
- The NAIC could use IFRS like it uses GAAP now, reviewing changes and deciding which ones to adopt
- The NAIC could adopt IFRS and Solvency II
 - Pressure from an OFC and Systemic Risk Regulator doing the same?

FINAL WORD

- Regardless of whether GAAP converges with it or is replaced by it, IFRS pronouncements and activities will continue to have a profound impact on accounting in the U.S.
- So, what does IFRS say about insurance?

IASB INSURANCE CONTRACTS PROJECT



STATUS

- Ongoing project since before 2001
- Split into short-term and a long-term projects in 2002
- IFRS 4 – *Insurance Contracts* issued in 2004
 - Aimed at the 2005 EU adoption of IFRS
 - Improved disclosures for insurance contracts
 - Made some modest changes to recognition and measurement of insurance liabilities
 - Pre-event Cat and Equalization reserves
 - No offset

STATUS

- Long-term project still ongoing
- No final guidance released yet – Discussion Paper only
- In the interim, companies continue to use IFRS 4 and their home-country GAAP rules for insurance reporting
- Pressure to harmonize and finalize

TIMELINE

- May 2007 – IASB issues Insurance Contracts Discussion Paper
- August 2007 – FASB issues an “Invitation to Comment” on whether they should join the project
- April 2008 – SEC announces plans for Roadmap
- October 2008 – FASB joins project
- December 2009 – Scheduled release of Exposure Draft (pushed back from October)

INSURANCE CONTRACTS DISCUSSION PAPER

■ Key Items

- Single Accounting Model
- Measurement Attribute
- Discounting Cash Flows
- Risk Margins
- Performance Reporting
- Day 1 Gains
- Own Credit Risk
- Unbundling

SINGLE ACCOUNTING MODEL

- ICDP written primarily from a life perspective
- Proposes a single model encompassing both, consistent with IASB's "principles based" focus

SINGLE ACCOUNTING MODEL

- Should there be a single model or are the differences too great?
 - Underwriting vs. investment focus
 - Reliability of cash flow projections
 - Presentation of results
- Always been a clear split between the two within industry

MEASUREMENT ATTRIBUTE

- IASB – Current Exit Value – essentially MTM
- Liabilities valued based on “transfer value” at the reporting date
 - The amount a third party would require to assume the liabilities

MEASUREMENT ATTRIBUTE

- Problem – no market for insurance liabilities
 - Non-fungible – insurance contracts are not standardized
 - Financial crisis has highlighted problems with illiquid markets

MEASUREMENT ATTRIBUTE

- Alternative

- Contract Fulfillment Value

- Assumes settlement of the liability with policyholders in the normal course of business
- Essentially what's being done now

MEASUREMENT ATTRIBUTE

- Other technical issues
 - What to use - management's best estimate or probability weighted?
 - Discounted or nominal?
 - Implicit vs. explicit risk margins
 - Need for a full reserve analysis every quarter?
 - Pre-event cat reserves non-zero?

DISCOUNTING CASH FLOWS

- Seen as technically correct and inevitable
- Questions remain on implementation
 - Entity specific vs. market based assumptions
 - Risk free rate or risk adjusted rate

RISK MARGINS

- Implicit or Explicit?
- Implicit = reflected in management's best estimate of claim liabilities
- Explicit = separate from claims liability
 - How to determine?
 - Cost of capital approach?
 - Confidence interval approach?
 - Is this “decision useful” information for financial statement users?

PERFORMANCE REPORTING

- Major area of concern
- Influence of life insurance accounting most clearly seen
- Current “GAAP” presentation or “Margin” presentation

PERFORMANCE REPORTING

- GAAP presentation
 - Premiums = income
 - Incurred losses = expense
- Margin presentation
 - Premiums = deposit
 - Income = risk margin + profit margin released over time

PERFORMANCE REPORTING

- A margin reporting format would eliminate many of the common metrics that the industry uses
 - Loss Ratio
 - Combined Ratio
 - Rate on Line?
- Would it provide “decision useful” information or would it destroy comparability and understandability?

DAY 1 GAINS

- ICDP raised the possibility that projected gains from an insurance contract would be recognized at inception
 - Should this happen?
 - Pre-claims liability – UPR or Risk Margin?
 - Profit earned over contract period (generally one year) or over the period of exposure (multiple years for casualty)

DAY 1 GAINS

- While companies would like to avoid recognizing Day 1 gains for accounting purposes, they would like to recognize them for solvency purposes
- IFRS being commented on by IAIS
- Tied up with Solvency II

OWN CREDIT RISK

- The cure for insolvency!
- Liabilities reflect the credit of the issuer

OWN CREDIT RISK

- As losses mount
 - Nominal liabilities increase, but
 - The Company is less likely to be able to meet them, so
 - Carried liabilities decrease!

UNBUNDLING

- Disaggregate contract into “deposit” vs. “insurance” components
- Disaggregation of contract income
 - Risk Margin
 - Profit Margin
 - Servicing Margin
- Does this provide “decision useful” information?

RECENT DEVELOPMENTS

■ Measurement Attribute

- February 2009 – FASB comes out in favor of contract fulfillment value vs. current exit value
- February 2009 – IASB leans toward contract fulfillment value 6-5
- April 2009 – IASB support for contract exit value still alive

RECENT DEVELOPMENTS

■ Measurement Attribute

- April 2009 – FASB supports measuring cash flows on a probability weighted basis vs. using management's single best estimate
 - Practicality – full reserve analysis each quarter?
 - Implications for pre-event cat reserves?

RECENT DEVELOPMENTS

- Risk Margins & Day 1 Gains
 - February 2009 – IASB supports determining initial risk margin to prevent day one gains
 - February 2009 – FASB against Day 1 Gains
 - April 2009 – IASB supports recognition of day one losses
 - A little inconsistent – carryover of conservatism

RECENT DEVELOPMENTS

- Risk Margins & Day 1 Gains
 - April 2009 – IASB discussed whether risk margins should be explicit and separate liabilities and if there should also be a service margin
 - April 2009 – FASB failed to reach a conclusion

MARK TO MARKET ACCOUNTING



MTM ACCOUNTING

- Hot topic in accounting and regulatory circles
- Important to insurance and reinsurance companies because of their large investment portfolios
- Connected to “Convergence” since influence over this topic may be giving U.S. regulators second thoughts
- Connected to the Insurance Contracts project since the IASB proposes marking insurance reserves to “market”

WHAT IS MTM ACCOUNTING?

- Value assets (and liabilities) at the current “market” price
- Much more prevalent in GAAP and IFRS than Statutory Accounting
- Has always been used for some items without controversy
 - Common stock of publicly traded companies
- Application to debt and structured securities (CDOs, etc.) more controversial

WHAT IS MTM ACCOUNTING?

- FAS 115 – *Accounting for Certain Investments in Debt and Equity Securities* - 1993
 - Held to Maturity
 - Trading
 - Available for Sale

WHAT IS MTM ACCOUNTING?

- FAS 157 – *Fair Value Measurements* - 2007
 - Didn't expand MTM accounting
 - Created a single definition of “fair value”
 - “...the price in an orderly transaction between market participants to sell the asset or transfer the liability...”

WHAT IS MTM ACCOUNTING?

■ Fair Value Hierarchy

- Level 1 – directly observable
 - Quoted prices in active markets for identical assets
- Level 2 – inputs other than Level 1 that are directly or indirectly observable
 - Quoted prices for similar assets in active markets
 - Quoted prices for identical or similar assets in non-active markets
- Level 3 – unobservable
 - “mark to model”

MTM AND THE FINANCIAL CRISIS

- The valuation of complex securities, especially mortgage backed CDOs, became a pressing issue as defaults increased
- Under MTM accounting the price at which another party sold such a security would become an input for other holders
 - Illiquid or “non-active” markets
 - “Fire sales” by distressed entities

MTM AND THE FINANCIAL CRISIS

- At the bequest of Congress, the FASB issued additional guidance on those issues
- Initial guidance was seen by some as “politicized”
- Final guidance was seen as a step back towards the principles of FAS 157

MTM AND THE FINANCIAL CRISIS

- The role that Fair Value or Mark to Market accounting played in the financial crisis is very controversial
- Detractors, including former Treasury Secretary Richard Rubin and former FDIC Chairman William Isaac argue that the adoption of MTM was a major cause, or at a minimum, deepened the crisis
- Supporters, including former SEC Chairmen Arthur Levitt and William Donaldson argue that MTM is required to provide transparency and restore confidence

MTM AND THE FINANCIAL CRISIS

- Widely accepted that MTM accounting is, at a minimum, very pro-cyclical
 - During boom times assets are written up, creating more equity and more capacity
 - During bust times assets are written down, destroying equity and capacity

SUMMARY



EVOLVING STANDARDS

- Accounting standards evolve over time
 - Adapt to new developments
 - Respond to latest crisis
 - “Punctuated Equilibrium”
- More harmonization
- Greater tie-in with regulatory concerns

ACCOUNTING UPDATE

CAGNY

June 2, 2009

Willis

© Stanhope by Hufton + Crow