Financial Accounting Standards Board

2009 Casualty Loss Reserving Seminar

September 14, 2009

Disclaimer

Expressions of individual views of members of the Financial Accounting Standards Board ("FASB") and its staff are encouraged. The views expressed in this presentation are those of Mark Trench. Official positions of the FASB on accounting matters are determined only after extensive due process and deliberations.

Current Status of Certain Projects*

- Revenue recognition
- Insurance contracts
  - Measurement
  - Acquisition costs

* For a complete list of the technical agenda and relevant projects at the FASB, please see the FASB website. In addition, all of the Board decisions discussed in this presentation are tentative and subject to change. Accordingly, the FASB website should be consulted for up to date decisions reached on those projects.

Decisions reached to date – Revenue recognition

- Discussion paper issued in December 2008
- Comment period ended in June 2009
- Exposure draft to be issued in 2010 (tentative)
- Final standard tentatively expected in 2011

Decisions reached to date – Revenue recognition

- Revenue recognition should be based on accounting for a contract with a customer
- When a company enters into a contract with a customer:
  - The company obtains rights to payment from the customer and
  - Assumes obligations to provide goods and services to the customer – “performance obligations”
- The combination of those rights and obligations result in a net contract position

Decisions reached to date – Revenue recognition

- Revenue is recognized when performance obligations are satisfied (that is, when it fulfils a promise to provide a good or service to the customer)
- Satisfaction occurs when a company has transferred the promised good or service
  - For a good, that typically occurs when the customer takes physical possession
  - For a service, that typically occurs when the customer has received the promised service
- For more than one good or service, revenue is recognized as each good or service is transferred to the customer

Decisions reached to date – Revenue recognition

- Revenue is the amount of the payment (consideration) received from the customer in exchange for transferring goods or services to the customer
  - If a company transfers goods and services at different times, it needs to determine how much of the total consideration to allocate to each performance obligation
  - Allocation to each performance obligation should be in proportion to the company’s stand-alone selling price for the promised good or service underlying each performance obligation
  - If that price cannot be observed, then it must be estimated

Decisions reached to date – Revenue recognition

- Remeasurement of performance obligation
  - Should be remeasured only when the contract has become "onerous"
  - "Onerous" is when a company's expected costs of satisfying a performance obligation exceed the carrying amount of that performance obligation
  - The carrying amount of an onerous performance obligation is increased to the company's expected costs of satisfying that performance obligation and a corresponding contract loss recognized
  - Discussion paper also considers other instances where the performance obligation should be remeasured

Decisions reached to date – Measurement objective

IASB

- Still a work-in-progress
- Currently considering an updated IAS 37 approach and fulfilment value
  - Updated IAS 37 approach objective is:

An insurer should measure an insurance liability at the amount it would rationally pay at the end of the reporting period to be relieved of the present obligation

FASB

- Current fulfilment value

The objective is to report a value based on the insurer's fulfillment of its contractual obligations to its policyholders

Decisions reached to date – How is the objective applied?

IASB

- Based on the premise that an active transfer market for insurance contracts is usually absent
- In most cases the liability would be measured at the value of not having to fulfil the obligation

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- Based on entity-specific inputs that generally would not require consideration of market participant views

Decisions reached to date – How is the objective applied?

IASB

- Use an expected present value technique that takes into account:
  - The value to the insurer of avoiding the future outflows expected to be required to fulfil the obligation
  - The value to the insurer of avoiding the risk in amount or timing of the outflows; and
  - The time value of money

FASB

- Use expected cash flows rather than a best estimate
  - CON 7 definitions

Best estimate: The single most-likely amount in a range of possible estimated amounts; the estimated mode

Expected cash flows refers to the sum of probability-weighted amounts in a range of possible estimated amounts; the estimated mean or average

Decisions reached to date – Features of measurement

IASB

- Building blocks
  - Use estimates of financial market variables that are as consistent as possible with observable market prices
  - Use explicit current estimates of the expected cash flows

FASB

- Use expected cash flows that are updated each period
- Consider all available evidence
  - All available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfillment of the contract

Decisions reached to date – Features of measurement

IASB

- Building blocks (cont)
  - Reflect the time value of money (decision pending on what the discount rate should be and whether it is udpated)
  - Include an explicit margin (currently considering both a risk margin and a service margin)

FASB

- Expected cash flows should be discounted and the discount rate should be updated (decision pending on what the discount rate should be)
- No explicit risk margin but does include a composite margin (the difference between the premium and the expected cash outflows)

Decisions reached to date – Day one differences

IASB

- The margin at inception should be measured by reference to the premium and therefore no day one gains should be recognized
- However, day one losses should be recognized in profit or loss

FASB

- In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit
- FASB to decide at a future meeting whether day one losses should be recognized in profit or loss

Decisions reached to date – Unearned premium approach

IASB

- Required use of unearned premium model for pre-claims liability for some short-duration insurance contracts (IASB decision, FASB decision pending)
  - Criteria to be developed
  - Claims liability would be discounted

FASB

- Decision pending (currently the unearned premium approach and revenue recognition are very similar)

Decisions reached to date – Claim liability

IASB

- Decided not to consider an approach that uses an estimate of future cash flows with no margins and no discounting

FASB

- Decision pending

Decisions reached to date – Contract boundaries

IASB

- Include in the expected (probability-weighted) cash flows those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts
- Distinguish old contracts from new contract by whether the contract can be cancelled or changed (such as price or other terms)

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- Decision pending based on discussions in revenue recognition project

Decisions reached to date – Acquisition costs

IASB

- Recognize as revenue the part of the premium that covers acquisition costs
- Acquisition costs are limited to the incremental costs of issuing (that is, selling, underwriting, and initiating) an insurance contract and not include other direct costs
- Incremental costs are those costs that the insurer would not have incurred if it had not issued those contracts

FASB

- Expense acquisition costs when incurred
- No revenue is recognized to cover acquisition costs

Topics to be discussed by IASB and FASB

- Residual and composite margins
  - Driver for release of margins
  - Period over which released
  - Should these margins be used as a "shock-absorber" for changes in expected cash outflows?
- Discount rate
  - What rate?
- Presentation
  - Gross or net presentation
  - Use of other comprehensive income for changes in financial variables
- Disclosures
  - Rollforwards, sensitivity analysis
- Scope and definition
  - Indemnification versus compensation
  - Risk transfer
- Reinsurance
- Level of aggregation for recognition and measurement

Timetable for project

- By December 2009:
  - Complete deliberations and issue exposure draft
    - May be different views included based on IASB and FASB views
  - Perform focused field testing for input into exposure draft
- Comments due May 2010
- Final standard June 2011
- Effective date – 2012 or 2013