201: Looking Back and Looking Forward
Annual Accounting & Auditing Update

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March 13th, 2012
40 Years Ago

• What was happening in the A&A world?

– In 1972 the AICPA’s code of Conduct was revised to remove the ban on competitive bidding. Prior to this, the code prohibited auditors from publicly advertising their services, making uninvited solicitations to rival firms’ clients, and from participating in competitive bidding for audits.

– In 1970, the Accounting Principles Board (APB), a committee of the AICPA issued Opinion No’s 16 and 17 on accounting for business combinations and goodwill. These opinions were very highly contested and received many dissenting votes from APB board members. Three of the Big Eight were so upset with the APB that they notified the APB that they had lost confidence in them. Interestingly enough, these APB Opinions were not superseded until the issuance of FAS 141 and 142 in June 2001.

– As a result the American Accounting Association formed a committee to look into developing an alternative to the APB. Not wanting to lose its standard setting power, the AICPA also created a committee that recommended the establishing the Financial Accounting Standards Board (FASB). In 1973, the AICPA transferred its responsibility for setting Generally Accepted Accounting Principles (GAAP) to the newly formed FASB. Prior to this all standards had been set by various committees of the AICPA.
Agenda

• **Highlights of Significant Accounting Changes Affecting our Industry**
  – For the Year Ended 2011
  – For the First Quarter & Year Ended 2012

• **Other Topics of Interest**
  – Clarity Project
  – SSAE 16 (SOC 1 report)
  – Private Companies Initiatives
  – PCAOB/SEC update
  – IFRS update including the insurance & lease joint projects
Public Entity Definition

- There are 4 different definitions of a “Public Entity” which could affect when an accounting standards update (ASU) is effective for some companies as well as some specific required disclosures.

  - One of the “Public Entity” definitions is as follows:

    a) Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.

    b) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

    c) It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

    d) It is required to file or furnish financial statements with the SEC.

    e) It is controlled by an entity covered by criteria (a) through (d).
Accounting Developments
For the Year Ended 2011
Accounting Development Year End 2011

- **U.S. GAAP (FASB)**
  - Fair Value Measurement (ASU 2010-06)

- **STAT**
  - Guarantee obligation (SSAP 5R)

- **Not Covered**
  - Credit Quality of Financing Receivables (ASU 2010-20)
  - Goodwill (ASU 2010-28)
  - Benefit Plans (ASU 2011-09)
  - Guarantee Fund and Other Assessment (SSAP 35R)
Fair Value (ASU 2010-06)

• Improving Disclosures about Fair Value Measurement (ASU 2010-06)
  – Issued January 2010
  – Portions were effective for fiscal years beginning after December 15, 2010
  • Level 3 roll forward presented on a gross basis
    – Purchases
    – Sales
    – Issuances
    – Settlements
SSAP 5R

• Liabilities, Contingencies and Impairments of Assets
  – SSAP 5R now requires recognition of liability at inception of guarantee obligation
  – Guarantees excluded from liability
    • made to/or on behalf of a wholly-owned subsidiary (insurance and non-insurance clarified in the Fall 2011 meeting)
    • intercompany and related party guarantees that are considered “unlimited”
    • Others listed in the SSAP pp. 15 & 16
  – Disclosures required for all guarantees
  – Effective for guarantees issued or outstanding as of December 31, 2011
Guarantee Disclosures

– Standard SSAP 5 contingency disclosures
– Nature of the guarantee
– Term
– How it arose
– How it would be triggered
– Impact to financial statement line items if triggered
– Current status of the payment/performance risk
– Potential future undiscounted payments that could be required; if unlimited, disclose that; if can’t estimate, disclose why
– Carrying amount of the liability (if recognized)
– Recourse options that may be available
Accounting Developments
First Quarter and Year
Ended 2012
Accounting Development
First Quarter and Year ended 2012

- **U.S. GAAP (FASB)**
  - Deferred Acquisition Costs (ASU 2010-26)
  - Fair Value Measurement (ASU 2011-04)
  - Comprehensive Income (ASU 2011-05 & 2011-12)

- **STAT**
  - Income taxes (SSAP 101)

- **Not Covered**
  - Goodwill (ASU 2011-08)
 Deferred Acquisition Costs

• Accounting for Costs Associated with Insurance Contracts (ASU 2010-26)
  – Issued in October 2010
  – Concern about diversity in practice relating to the interpretation of which costs qualify as acquisition
  – New definition: Costs that are directly related to the successful acquisition of new or renewal insurance contracts.
Significant Changes

• Some insurance entities capitalize costs relating to unsuccessful contract acquisitions. Costs must now be based on “successful efforts”.

• Some entities capitalize rent, software, administrative costs... related to their acquisition activities. Costs must now be expensed.

• Advertising costs only should be included as deferred acquisition costs if the direct-response advertising criteria are met.
Deferred Acquisition Costs

• Types of costs eligible for **Capitalization**?
  
  – A) **Incremental Direct Costs of Contract Acquisition** which meet the following characteristics:
    
    • Results directly from and is essential to the contract transaction(s)
    
    • Would not have been incurred by the insurance entity had the contract transaction(s) not occurred
Deferred Acquisition Costs

B) Portion of employees’ total compensation and payroll-related benefits directly related to the successful acquisition of a contract (excluding any compensation that is capitalized as incremental direct costs)

C) Other direct costs related to acquisition activities that would not have been incurred by the insurance entity had the contract not occurred

D) Advertising costs that meet the capitalization criteria
Compensation Cost & Success (Hit) Rate

• Portion of employees’ total compensation and payroll-related benefits
  – How to determine compensation costs?
    • Standard Costing: Estimated or predetermined cost of performing a service, under normal conditions (examples: homogeneous contracts, specific contracts...)
    • Identified separately
    • Or a combination
  – How to determine success or hit rates?
    • % of placement rate versus quoted rate
    • % of placement rate versus submission rate
Deferred Acquisition Costs

• Transition
  – Prospectively (disclose A or B)
    • The amount of acquisition costs that would have been capitalized the period immediately preceding adoption (i.e. what would last year’s DAC have been if we had used the new method?)
    • The amount of acquisition costs that would have been capitalized during the period if the entity's previous policy had been applied (i.e. what would this year’s DAC have been if we used the old method?)
  – Retrospectively (permitted)
Transition

Example: Assuming Company did not early adopt

Prospective (A)

<table>
<thead>
<tr>
<th>Balance Sheets</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>DAC</td>
<td>$20,500</td>
<td>$21,000</td>
</tr>
</tbody>
</table>

Prospective (B)

<table>
<thead>
<tr>
<th>Balance Sheets</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>DAC</td>
<td>$20,500</td>
<td>$21,000</td>
</tr>
</tbody>
</table>

Note to AFS: Had the Company recorded DAC in 2012 using the previous guidance, DAC would have been $23,000
Transition

Example:

<table>
<thead>
<tr>
<th></th>
<th>Old Guidance</th>
<th>New Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$20,000</td>
<td>$17,500</td>
</tr>
<tr>
<td>2011</td>
<td>$21,000</td>
<td>$19,000</td>
</tr>
<tr>
<td>2012</td>
<td>$23,000</td>
<td>$20,500</td>
</tr>
</tbody>
</table>

Retrospectively

<table>
<thead>
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<th>2012</th>
<th>2011</th>
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<td>$19,000</td>
</tr>
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An adjustment to beginning Retained Earnings of $1,625 would be recorded as of January 1, 2011

$20,000-$17,500=$2,500 ($1,625 net of 35% tax)
Examples

• Q- Our Company is assessed 3% of GWP (gross written premiums) for underwriting services provided by a MGA. Can we defer these fees?

• A- Yes, these fees are incremental direct costs and relate to successful contract acquisition. They would not have been incurred by the insurance entity had the contract not occurred.
Examples

- Q- Our Company is assuming risks through a fronting agreement. Can we defer these costs? The fees charged are as follows:

  - Front 6% - Yes
  - Underwriting/Processing 5% - Yes
  - Taxes & B&B 3.9% - Yes
  - Loss Prevention & Premium Audit 2% - No
  - Commissions 15.1% - Yes
  - Overhead expenses 2% - No
  - Claims handling 5% - No

  Total Ceding Commission 39%
Examples

• Q- Our Company is charged 8% of GWP for underwriting and claim handling services provided by a TPA. Can we defer these costs?

• A- No. These costs are incremental, however, claim handling services are not directly essential to the acquisition of the contract.
Examples

• Q- How can we defer the portion related to the underwriting services?

• A- You can amend the contract whereby, the % charged would be specifically allocated between underwriting and claim handling services and the % related to underwriting services would be deferrable.
Fair Value (ASU 2011-04)

• Fair Value Measurement (ASU 2011-04)

• Issued May 12, 2011 resulting from convergence process with IASB

• Effective Date:
  – Public Entities and Non-Public Entities - Periods beginning after December 15, 2011
Fair Value (ASU 2011-04)

• Primary Measurement Changes
  – Application of Premiums & Discounts
    • In absence of Level 1 input Premium & Discounts can be considered, if
      – Application is consistent with characteristics of the asset or liability
      – Market would take these characteristics into account; and
      – Application is consistent with unit of account specified in other guidance that requires or permits the FV measurement
Fair Value (ASU 2011-04)

• **Primary Measurement Changes**
  
  – **Own Equity** Instruments Classified within Shareholders’ Equity
    
    • Requires measurement from perspective of a market participant holding identical instrument as an asset

  – “Highest and Best Use” and “Valuation Premise”
    
    • Clarifies that use of these concepts are only applicable to non-financial asset and liability
Fair Value (ASU 2011-04)

- **Primary Disclosure Changes**
  - **Level 3** Measurements - **Require** disclosure of *quantitative* information about the unobservable inputs including:
    - **All** - Valuation process used including policies, procedures and analysis of period-to-period changes
    - **Public Entities** - Narrative description by class of asset of sensitivity of the FV measurement to changes in the unobservable inputs
Fair Value (ASU 2011-04)

- **Primary Disclosure Changes**
  - New **Public** Company Disclosures
    - FV Hierarchy disclosure
      - Items not at FV on face of financial statements for which FV is required to be disclosed (e.g. held-to-maturity investments)
    - Transfer between Level 1 and Level 2
      - Previously only required disclosure of **significant** transfers
      - Now requires disclosure of **ALL** transfers
      - Non public entities now exempt
  - “Highest and Best Use” and “Valuation Premise”
    - Current use differ from “Highest and Best Use” of non-financial asset
    - Disclose of reasons why it is being used differently
OCI (ASU 2011-05 & 2011-12)

• Presentation of Comprehensive Income (ASU 2011-05)
  – Eliminates ability to present components of Other Comprehensive Income (OCI)
    • Within Statement of Changes in Stockholders’ Equity
    • Separate Statement
  – Conforms GAAP to IFRS
OCI (ASU 2011-05)

- **Presentation of Comprehensive Income (ASU 2011-05)**
  - New **OPTIONS**
    - **Single** continuous “Statement of Comprehensive Income”
    - Separate but **Consecutive** statements
  - Presentation
    - Present **Reclassification Adjustments** between OCI and net income separately on the **FACE** of the financial statements
  * Deferred by FASB in December by ASU 2011-12
SSAP 101- Income Taxes

• Effective date-January 1, 2012
• Key differences to SSAP 10/10R
  – Eliminated **OPTIONAL** election to admit additional DTAs
  – Included complicated Realization Threshold Limitation Tables
    – Three tables
  – Recognition of tax loss contingencies (~Fin 48)
  – Disclosure Changes
SSAP 101

• Tax Contingencies
  – Specific FIN 48 provisions were dropped
  – Added requirement to recognize a liability for income tax loss contingencies (SSAP 5R)

• 3 Admissibility Steps➡️➡️➡️➡️➡️➡️➡️
SSAP 101
Admissibility Step 1

• Reversing that could be carried back against prior year FIT payments
SSAP 101
Admissibility Step 2

• ExDTA ACL RBC
  – December 31
    • Numerator: Dec 31 total adjusted capital excluding the net DTA
    • Denominator: Dec 31 authorized control level RBC
  – For interim periods
    • Numerator: Current quarter total adjusted capital excluding the net DTA
    • Denominator: Previous year-end ACL as filed with the NAIC
### SSAP 101

**Admissibility Step 2**

**The lesser of**

<table>
<thead>
<tr>
<th>ExDTA ACL RBC</th>
<th>DTA’s Reversing Within X Years of the BS Date</th>
<th>Amount Not Greater Than X% of Adjusted Surplus *</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 300%</td>
<td>3 years</td>
<td>15%</td>
</tr>
<tr>
<td>200%-300%</td>
<td>1 year</td>
<td>10%</td>
</tr>
<tr>
<td>&lt; 200%</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>

Note: This table applies only to insurers that file RBC. Other insurers must consult the standard for the corresponding table that applied.

(*) Current period surplus excluding DTA, EDP, operating software and goodwill
### SSAP 101 – Admissibility Step 2

#### Financial/Mortgage Guaranty Entities

**The lesser of:**

<table>
<thead>
<tr>
<th>ExDTA Surplus/Policyholders and Contingency Reserves</th>
<th>DTA’s Reversing Within X Years of the BS Date</th>
<th>Amount Not Greater Than X% of Adjusted Surplus *</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 115%</td>
<td>3 years</td>
<td>15%</td>
</tr>
<tr>
<td>100%-115%</td>
<td>1 year</td>
<td>10%</td>
</tr>
<tr>
<td>&lt; 100%</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>

(*) Current period surplus excluding DTA, EDP, operating software and goodwill
### Other Non-RBC Reporting Entities

**The lesser of:**

<table>
<thead>
<tr>
<th>Adjusted Gross DTA/Adjusted Capital Surplus</th>
<th>DTA’s Reversing Within X Years of the BS Date</th>
<th>Amount Not Greater Than X% of Adjusted Surplus *</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 50%</td>
<td>3 years</td>
<td>15%</td>
</tr>
<tr>
<td>50%-75%</td>
<td>1 year</td>
<td>10%</td>
</tr>
<tr>
<td>&gt; 75%</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>

(* ) Current period surplus excluding DTA, EDP, operating software and goodwill
SSAP 101
Admissibility Step 3

• DTAs in an amount not to exceed recognized DTLs
  – Only to the extent that the character of the DTAs match the DTLs
Other Topics of Interest
The Clarity Project
The Clarity Project

• In 2004, the Auditing Standards Board (ASB) commenced the Clarity Project with two objectives:
  – Make US auditing standards more comprehensive and applicable
  – Converge US GAAS with International Standards on Auditing (ISA)
SAS Codification

• Most recently issued SAS include:
  – SAS No. 122, Statements on Auditing Standards: Clarification and Recodification
  – SAS No. 123, Omnibus Statement on Auditing Standards
  – SAS No. 124, Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country
  – No. 125, Alert That Restricts the Use of the Auditor’s Written Communication

• Effective for periods ending on or after December 15, 2012

• Early adoption of SAS No. 122-125 NOT permitted
SSAE 16 Service Organization Controls- (SOC 1) Report
SOC 1 Report Background

- **SSAE 16 SOC 1** report replaces SAS 70 standard for reports (Type I and Type II) on internal controls over financial reporting at service organizations.

- Effective for reports issued on or after June 15, 2011.
Significant Changes under SSAE 16

- Changes that will affect a service organization:
  - Inclusion of a signed management assertion and the a reasonable basis for the assertion
  - Description of the organization’s system under Type II engagements
  - Expansion of the opinion on the design of controls under Type II engagements
Blue Ribbon Panel
Blue Ribbon Panel (BRP) Background

• The BRP was formed in 2009 by the AICPA, the Financial Accounting Foundation (FAF) and NASBA

• Mission - to address how accounting standards can best meet the needs of U.S. users of PRIVATE company financial statements

• January 2011 - BRP report recommended that FAF create an autonomous, authoritative standard-setting board for private company issues
Arguments for Separate Accounting Standards

• Increased complexity of accounting standards continue to pose difficulties for non-public companies

• Costs to comply with standards outweigh the benefits to financial statement users

• Comparability is often compromised because many non-public companies use GAAP exceptions or shift to other comprehensive basis of accounting (OCBOA) statements
FAF Conclusion

• Concluded that two separate sets of U.S. accounting standards was not desirable
• Proposed to establish the Private Company Standards Improvement Council (PCSIC), chaired by the member of the FASB
• Mission of the PCSIC – determine whether exceptions/modifications to US GAAP are required to address the needs of users of private company financial statements
Private Company Plan
Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116
PrivateCompanyPlan@f-a-f.org

Re: Plan to Establish the Private Company Standards Improvement Council

This comment letter represents my own professional views.

Dear Financial Accounting Foundation:

Despite the strong recommendations of the Blue Ribbon Panel, and upon receiving support for those recommendations from many constituents, FAF’s proposal does not contemplate the creation of an authoritative independent standard setter for private companies. The new Private Company Standards Improvement Council, as proposed, does not solve the systemic problems that exist with standard setting for private companies because it requires the Financial Accounting Standards Board to ratify any suggested modifications. I urge you to establish a new independent standard-setting body whose decisions would not be subject to the FASB approval process. It is the best way to make meaningful financial reporting changes for private companies a reality.

Thank You.

Regards,

Your name will be included in the comment letter sent to FAF.
PCAOB/SEC Update
PCAOB/SEC

• Hot topic
  – Management’s and auditors’ responsibilities related to information received from Pricing Services
    • SEC and PCAOB staff members stressed the importance of auditors’ procedures to adequately challenge the valuation assertion for investments, especially those that are not exchange-traded

• Comply with GAAP management must:
  – Consider the valuation techniques and assumptions used by the pricing service, particularly in markets in which securities are not actively traded
  – Required to maintain a system of internal control over financial reporting. Noted a significant and concerning increase in inspection findings.
PCAOB/SEC

• **Management needs to:**
  – Challenge the price
  – Monitor the pricing services assumptions
  – Obtain independent audit reports on the internal controls of pricing services.

• **Auditors need to**
  – Understand how the values were determined
  – Understand the inputs and the assumptions
  – Test the underlying methods and assumptions used to value harder-to-value financial instruments
Auditor independence and audit firm rotation No. 2011-006

Ways that auditor independence, objectivity and professional skepticism could be enhanced

- Mandatory Audit Firm Rotation

Proponents

- Setting a limit on the continuous stream of audit fees could free the auditor, to a significant degree, from the effects of management pressure
- Offer an opportunity for a fresh look at the company's

Opponents

- Cost
- Audit quality may suffer in the early years of an engagement and that rotation could exacerbate this situation
- Loss of knowledge
- Decrease in audit efficiencies
PCAOB Concept Release No. 2011-003

• Possible revisions to PCAOB standards related to reports on audited financial statements No. 2011-003
  – Increase its transparency and relevance
    • Supplement to the auditor's report with an "Auditor's Discussion and Analysis"
    • Required expanded use of emphasis paragraphs
      – Boilerplate (std par. with no substance)
    • Auditor reporting on information outside the financial statements
    • Clarification of certain language in the auditor's report.
• AD&A
  – Significant matters
  – Audit risks
  – Audit procedures and results
  – Auditor independence
  – Discussion of the auditor’s views or impressions regarding management’s judgments and estimates, accounting policies and practices and difficult or contentious issues, including “close calls.”
• Auditors’ Report
  – Reasonable assurance
    • Describe "high level of assurance, but not absolute assurance."
  – Auditor's responsibility for fraud
  – Auditor's responsibility for financial statement disclosures
  – Management's responsibility for the preparation of the financial statements
  – Auditor's responsibility for information outside the financial statements
  – Auditor independence
    • Include a statement
PCAOB Concept Release No. 2011-008

- Proposed auditing standard related to communications with audit committees No. 2011-008
  - Enhance the relevance and quality of the communications between the auditor and the audit committee
    - Reproposed Dec 20, 2011
    - Due date Feb 29, 2012
  - May require communications occur prior to report release date
  - Require to communicate significant unusual transactions that are outside the company’s normal course of business or appear to be unusual
– Engagement letter be provided to the audit committee annually

– Required the auditor to inquire whether the audit committee was aware of matters that may be related to the audit, including complaints or concerns raised about accounting, auditing, knowledge of violations or possible violations of laws or regulations

– Required the auditor to communicate whether persons with specialized skill or knowledge would be needed to apply the planned audit procedures or evaluate the audit results for significant risks
Adoption of IFRSs

• **SEC’s Views**
  – Framework would provide
    • Clear U.S. authority over standards applicable in the U.S. capital markets
    • Strong U.S. voice in the process of establishing global accounting standards
    • Responsive to the economic and other impacts of change
      – **Condorsement Approach**
Adoption of IFRSs

• FASB’s Views
  – Incorporation Approach
    – Boards would complete their priority convergence projects
    – Would refrain from separately engaging in standard setting on new technical projects added to the IASB’s technical agenda.
    – Although, would provide implementation guidance in cases where international guidance is not timely or does not provide detail needed for appropriate investor protection.
    – Would develop a process to address substantial differences that remain between U.S. GAAP and IFRS and would incorporate international standards into U.S. GAAP if it improves the quality of financial reporting already in place in the U.S.
IFRS Recent Development

• On Feb 20, 2012 the SEC Chief Accountant James Kroeker implied that he and his staff were gravitating toward the "endorsement" approach
  • Under the *endorsement* approach, jurisdictions incorporate individual IFRSs into their local body of standards. Many of these jurisdictions use stated criteria for endorsement, which are designed to protect stakeholders in these jurisdictions.

• He said later that the SEC will receive a proposal in the coming months about such a switch.
Joint Project - Insurance Contracts

Objectives:

– Reduce diversity of accounting practices that currently exist for insurance contracts

– Align insurance accounting with other business sectors, where possible

– Increase users’ understanding of insurance financial statements

– Help investors make decisions
History

History of Convergence: Insurance Contracts

- IASB Discussion Paper (May '07)
- Invitation to Comment (August '07)
- FASB Joins IASB (October '08)
- IASB Publishes Exposure Draft (July '10)
- FASB Issues Discussion Paper (September '10)
- IASB Comment Letter Deadline (November '10)
- FASB Comment Letter Deadline (December '10)

Expect to re-expose second half of 2012
<table>
<thead>
<tr>
<th>Feature</th>
<th>IASB Exposure Draft</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model- General Measurement Approach (Building Block Approach)</td>
<td>A single model –Life, non-life, direct, reinsurance</td>
</tr>
<tr>
<td>Recognition</td>
<td>Consistent with financial instruments –when the insurer is bound by the terms of the contract or first exposed to risk</td>
</tr>
<tr>
<td>Unearned Premium (UEPR)</td>
<td>Premium Allocation Model applies for certain short-duration contracts</td>
</tr>
<tr>
<td>Measurement</td>
<td>Fulfillment value --Four building blocks</td>
</tr>
<tr>
<td>Acquisition Costs</td>
<td>Incremental acquisition costs recognized in the future cash flows; non-incremental acquisition costs recognized as expense when incurred</td>
</tr>
</tbody>
</table>
## Building Block Approach

### IASB

<table>
<thead>
<tr>
<th>Block</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Block 1</td>
<td>Estimate of <strong>Future Cash Outflows less Cash Inflows</strong> that will arise as the insurer fulfils the insurance contract</td>
</tr>
<tr>
<td>Block 2</td>
<td><strong>Discount Rate</strong> that adjusts those cash flows for the time value of money</td>
</tr>
<tr>
<td>Block 3</td>
<td><strong>Risk Adjustment</strong> for the effects of uncertainty about the amount and timing of those future cash flows</td>
</tr>
<tr>
<td>Block 4</td>
<td><strong>Residual Margin</strong> to eliminate any gain at inception</td>
</tr>
</tbody>
</table>

### FASB

<table>
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</tr>
<tr>
<td>Block 3</td>
<td><strong>Composite Margin</strong> to eliminate any gain at inception and includes an implicit risk adjustment margin and residual margin</td>
</tr>
</tbody>
</table>

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**PV of Fulfillment Cash Flows**
Loss Reserves - Changes

Old Way

Estimated Undiscounted Reserves

New Way

Sum of Projected Paid Loss Cash Flows

Less Amount of Discount

Estimated Discounted Reserves

Plus Risk Adjustment

Estimated Discounted Reserves
Net Effect on Loss Reserves at 12 Months Maturity

Discount Rate

Effect on Reserves

WC
$100M Annual E-Losses
• 10-Year E-Payout
• Year 1 E-Paid Losses $15M
• E-Reserves end Y1 $85M
Joint Project- Leases

• Exposure draft issued in August 2010
  • Comment period ended December 15, 2010
  • 786 comment letters received

• Boards currently discussing the comments received
  • Expect to re-expose revised proposals second quarter of 2012

• Would change how leases are accounted for
  • Right-of-use model in accounting for all leases
    – Capital Leases
    – Operating Leases
  • Leases less than 12 months (Simplified Requirements)
Why the Lease Project

• Existing lease accounting does not provide useful information to users
  – Accounting depends on classification

• Complex because of dividing line between finance and operating leases
Long-Term Leases

• Lessee Accounting Model (Re-Proposal)
  – Lessee has acquired the **right to use** an underlying asset and is paying for that right with its lease payments

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Right-of-use asset</td>
<td>• Amortization expense</td>
</tr>
<tr>
<td></td>
<td>X</td>
</tr>
<tr>
<td>• Liability to make lease payments</td>
<td>• Interest expense</td>
</tr>
<tr>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
Long-Term Leases

- Lessor Accounting Model (Re-Proposal)
  
  - Lessor has provided lessee with a right to use an underlying asset and has obtained a right to receive lease payments. Lessor retains residual interest
  
  - **Receivable and residual approach.** All leases except short-term and investment property

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>• Residual asset</td>
<td>• Profit on transfer of right-to-use</td>
</tr>
<tr>
<td>• Right to receive lease payments</td>
<td>• Accretion of residual asset</td>
</tr>
<tr>
<td></td>
<td>• Interest income</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Short-Term Leases

• No requirement to recognize assets and liabilities, recognize *rent expense*

• Defined as leases for which the maximum possible lease term is 12 months or less
Thank You for Joining Us

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