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# Insurance Accounting Newsletter
## Almost there ...

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) continued with their regular meetings in May and managed to address most of the remaining issues to be covered by the Exposure Draft (ED). Further meetings are planned for June and the publication date of the ED has unofficially been moved to July 2010 and is likely to be before the July IASB meets again that month.

As well as meeting twice in May, the FASB & IASB also met for a special meeting on 1st June. The Boards have made good progress, although there are still a number of disagreements which will result in alternative approaches being presented in the ED.

The Staff made a final attempt to resolve the disagreement over the accounting for uncertainty using an explicit risk adjustment or a composite margin model. Although the Boards did not reach a consensus, they agreed on how each approach should be applied enabling their Staff to make progress with the drafting of the ED.

A number of other topics were discussed and agreed upon in the May and 1 June meetings including: risk adjustment valuation techniques; release of margins; unbundling; and scope. Additional Staff work on the finalisation of disclosure requirements was requested.

In summary, the Boards have now agreed that:

### Transition issues

- On transition to the new accounting standard the net carrying amount associated with insurance contracts (i.e. liabilities net of any deferred acquisition cost or similar asset) will be compared against the amount based on the three-building blocks approach. No residual margin will be recognised with any positive or negative difference accounted for directly in equity.

- If the composite margin model is adopted, the opening balance will be based on the risk adjustment. However it will subsequently be released to income based on the proposed formula.

### Margins

- If a separate risk adjustment is included it should be measured at portfolio level and the range of permitted techniques to calculate will be narrowly defined.

- Composite or residual margins should be determined as a minimum at cohort level defined as the group of contracts from the same portfolio that have been recognised in one financial year and have similar expected lives.

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- Determination of these margins at contract level will be allowed.

- The definition of a portfolio of insurance contracts will be based on the current IFRS 4 definition which requires the dual test of risk homogeneity and managed as a single portfolio to be passed.

Unbundling

- Unbundling should be required for explicit account balances arising from account driven contracts and a question will be asked in the ED as to whether non-explicit account balances should also be unbundled.

- Unbundling will be prohibited when it is not required.

- The Boards were unable to reach agreement on whether to unbundle embedded derivatives based on existing bifurcation requirements (preferred by the IASB), or unbundle using the same principle proposed for other components of the contract (preferred by the FASB).

Scope

- Fixed fee service contracts will be scoped out even if they meet the definition of insurance.

- Financial guarantee contracts that meet the definition of an insurance contract will be in scope.

Business combinations and portfolio transfers

- An exception to the fair value principle has been agreed for business combinations where the three building blocks approach will have to be used inclusive of a composite/residual margin when the difference with fair value is positive (negative differences will go immediately to income). Portfolio transfers will follow the same approach with reference to the transaction price.

## Risk adjustment and composite margins

Despite additional discussions, the two Boards have been unable to reach agreement on whether to use a risk adjustment and residual margin model (marginally favoured by the IASB) or a composite margin model (marginally favoured by the FASB). As a result, both views will be presented in the ED and the respondents' preference will be sought.

The Boards have, however, agreed that should an explicit risk adjustment model be selected the standard would offer a limited range of techniques to calculate the risk margin.

Among the possible techniques discussed are a cost of capital approach (using economic capital rather than regulatory capital), stochastic modelling, sensitivity/stress testing and a calibration to capital markets or insurance pricing. The Boards have requested that the Staff considers these techniques and produce guidance on which method would be considered appropriate for particular circumstances or products.

The Boards have further agreed (IASB: 8 in favour, FASB: unanimous) that, should a composite margin model be selected, the release of that margin should be governed by specific drivers used in a particular amortisation formula. The drivers to be used are still under discussion as the Boards have asked that they capture the risk and uncertainty inherent in insurance contracts. There remains reluctance among some Board members to amortise rather than remeasure the composite margin.

## Level of measurement

The Boards agreed almost unanimously (only one dissenting vote) with the Staff recommendation that, if a separate risk adjustment is included, the adjustment should be determined at the level of a portfolio of insurance contracts. The Boards agreed unanimously to retain the current IFRS 4 definition of a portfolio of insurance contracts, i.e. "contracts that are subject to broadly similar risks and are managed together as a single portfolio". Therefore, the risk adjustment will not reflect the effects of diversification between portfolios, i.e. will not capture any negative correlations between portfolios.

The Boards have unanimously agreed with the Staff recommendation that residual and composite margins should be measured, both initially and subsequently, at a cohort level that groups the insurance contracts:

- by portfolio (as defined by the current IFRS 4), similar to the risk adjustment;

- by date of inception of the contract, should the contracts form part of the same portfolio; and

- by the length of life remaining to the contract.

The Boards further agreed that composite margins could be measured at an individual contract level.

## Disclosures

The Staff recommended the following high level disclosure requirements:

- that qualitative and quantitative information should be disclosed about the amounts arising from insurance contracts and the nature and extent of risks arising from insurance contracts;

- any additional information considered necessary to meet the disclosure objective should be disclosed;
- aggregate disclosure is permitted, but only to the extent that it does not obscure any useful information;
- information sufficient to permit reconciliation with the primary statements should be provided; and
- aggregation of data should be capped at a level no larger than an operating segment as defined under IFRS 8.

The Boards had a number of concerns about these recommendations and no formal vote took place. The concerns primarily related to:

- the exclusion of cash flows, as none of the proposed disclosure requirements seem to provide information on the nature of future cash flows; and
- the practicability of the disclosure requirements as currently proposed, with Board members commenting that large multi-national insurers applying the principles as written may well result in voluminous disclosure which would obscure the relevant information.

The Boards asked the Staff to reconsider the proposals to ensure they are responsive to the needs of users of the financial statements, and to take into account their comments.

## Unbundling

The Staff proposed the unbundling principle to be worded as "A component of an insurance contract should be unbundled if it functions independently from other components of that contract. A component functions independently if it is not significantly interdependent with other components of that contract."

The Boards were concerned that the proposed wording does not capture the notion that components which are not insurance should be unbundled from the contract. Some Board members raised further concerns about the effect that the current proposed approach would have on embedded derivatives, as well as the potential for entities to engage in accounting arbitrage between insurance contracts and financial instruments.

The Boards could not agree with the Staff proposal, and commented that 'significantly interdependent' needs to be better defined. It was argued that, in most cases, all components of a contract are interdependent, so without a solid basis to define 'significantly', no component would be unbundled.

In relation to contracts with an explicit policyholder account balance ("account-driven contracts") the Boards agreed that they should be unbundled. The Boards instructed the Staff to address account-driven contracts by building on existing US guidance (ASC Topic 944-20-15-29).

In relation to insurance contracts which contain embedded derivatives, the Staff proposed two alternatives for unbundling:

- use the existing bifurcation requirements for embedded derivatives; or
- use the same unbundling principle that is proposed for all other components of an insurance contract.

The Boards were unable to reach agreement, with the IASB narrowly voting to use the existing bifurcation requirements, and the FASB favouring the use the insurance contract unbundling principles. Both options will be presented for comment in the ED.

The Boards agreed unanimously to forbid unbundling in any circumstance where unbundling is not explicitly required by the relevant accounting rules.

## Fixed-fee service contracts

The Staff's proposal to include in the scope of the insurance standard fixed-fee service contract that meet the definition of an insurance contract was rejected on the grounds Board members felt it took the insurance approach to the extreme, resulting in insurance accounting being applied to contracts that are clearly not insurance. The Boards voted against (IASB – 11:4 majority; FASB – unanimous) the Staff proposal scoping out of IFRS 4 Phase II all fixed-fee service contracts.

## Classification of financial guarantees

The Staff recommended that contracts, such as financial guarantees that indemnify the holder for specific defaults, which meet the definition of an insurance contract, should be accounted for as insurance contracts.

The Boards agreed (IASB – 13:2 majority; FASB – 4:1 majority) with their Staff that the definition of insurance contracts would not capture credit derivatives. These will continue to be accounted for under IAS 39.

## Transitional arrangements

At the joint meeting on 1st June, the two Boards discussed the Staff proposals for transitional provisions to implement the new standard. The Boards rejected the proposal that, for the earliest period presented, existing insurance liabilities should be determined by reference to the expected present value of future cash flows, including any necessary risk adjustment, with negative differences from the comparison with previous GAAP written off to retained income and positive differences recognised as a residual margin (or composite margin if the expected value without risk adjustment is used).

The rationale for this rejection was the result of creating non comparable profits perpetuating the issues tolerated under IFRS 4 Phase I.

The Boards tentatively agreed that existing insurance liabilities should be valued using the building blocks plus risk margin approach in all cases. Under the composite margin model this risk adjustment would be deemed the initial composite margin balance.

Any difference from the previous value of the liability, whether positive or negative, would be taken to opening retained income.

In all cases any deferred acquisition cost asset or other similar insurance intangible asset would be written off entirely.

In order to maintain understanding and comparability, the Boards tentatively decided to require a separate run off of the opening margin and all margins subsequently recognised with the sale of new contracts.

On transition, the Boards decided unanimously to permit, but not require, financial assets reclassifications at a portfolio level only rather than for individual assets. This reclassification would be permitted only to reclassify assets at fair value from amortised cost with no permission to reclassify out of the fair value category.

Finally, the IASB considered whether it would permit early adoption of the standard. Although no formal decision was made, the Board members commented that early adoption was unlikely to be permitted.

## Business combinations

The two Boards discussed the measurement, at the date of acquisition, of insurance contracts assumed in a business combination or portfolio transfer.

In both instances the Boards agreed that the valuation of the liabilities at the present value of future cash flows plus risk margin should be the only form of valuation acceptable. Any positive difference would be accounted for as a residual or composite margin, and any negative differences would be taken directly to profit and loss.

For business combinations, after much discussion, the Boards reluctantly agreed with the Staff recommendation and accepted an exception to the fair value principle in business combination accounting. On the grounds that the fair value of an insurance contract liability is likely to be lower than its fulfilment value, the Boards also accepted that this would increase goodwill.

## Contract boundaries (FASB only meeting)

In a FASB only meeting on 5 May, the FASB discussed the issue of contract boundaries that had previously been addressed by the IASB. The FASB decided unanimously that the boundary of an insurance contract is the point at which the insurer either is no longer required to provide coverage or has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects the risk. This decision is substantially the same as that reached by the IASB.

## Outstanding issues and timetable

Although the Boards have agreed to disagree on several issues, and will therefore release an ED with multiple options, there are still a number of issues to be covered before at the remaining June meeting before the ED is released in July 2010:

- Scope consideration for investment contracts with discretionary participating features (scheduled for 10 June).
- Cash flow guidance (scheduled for the Board week on 15 June).
- Follow-up on acquisition costs recoverable on lapse (scheduled for the Board week on 15 June).
- Follow-up on reinsurance (scheduled for the Board week on 15 June).
- Follow-up on a simplified measurement (‘unearned premium approach’) (scheduled for the Board week on 15 June).
- Follow-up on presentation (scheduled for the Board week on 15 June).

**Appendix – Summary of tentative decisions to date**

| Converging tentative views | IASB & FASB |
|---|---|
| Scope of the insurance standard | The following are excluded from the scope of the insurance standard:<br>• warranties issued directly by a manufacturer, dealer or retailer;<br>• residual value guarantees embedded in a lease;<br>• residual value guarantees issued directly by a manufacturer, dealer or retailer;<br>• employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans; and<br>• contingent consideration payable or receivable in a business combination. |
| Definition of insurance and evaluation of significant insurance risk | The IFRS 4 terminology "compensation" will be used in the standard rather than the US GAAP terminology "indemnification".<br>Significant insurance risk will be evaluated using present values rather than absolute amounts and the role of timing risk in identifying insurance risk should be disqualifying rather than a primary condition for determining significant insurance risk in a contract. There is, however, a disagreement between the IASB and the FASB on the "loss test". See below. |
| Measurement objective and approach | Although both Boards agree on using a building block approach, which blocks should be included in the approach has become a point of disagreement for the Boards. The disagreement revolves around whether to use a separate risk adjustment or a composite margin. Details of the disagreement have been included below. |
| Measurement approach | The measurement approach will be applied to the overall insurance contract to produce one carrying amount inclusive of all rights and obligations rather than separate asset and liability components. |
| Measurement objective | The measurement objective will refer to the value rather than the cost of fulfilling the obligations under the insurance contract. The Staff are to propose further refinement of the measurement objective wording. |
| Contract boundary | An existing contract terminates when the insurer has an unconditional right to re-underwrite/re-price that individual contract. |
| Service margin | No explicit service margin is included in the measurement approach. |
| Subsequent treatment of margins | The release of residual margin to profit or loss will be independent of changes in the value of estimates within the three-building-blocks. The margin will be released on a straight line basis over the coverage period unless the expected claims/benefits pattern provides a better systematic and rational basis. |
| Use of inputs for measurement | All available information relevant to the contract should be used. Current estimates of financial market variables must be consistent with observable market prices. |
| Non performance risk | Prohibition from taking changes in the insurer's non-performance risk (including own credit risk) into account in subsequent measurement of the insurance contract. |
| Accounting profit | Prohibition from recognising accounting profit at initial contract recognition. |
| Negative day one differences | Recognise negative day one difference immediately as a day one loss. Further discussion planned to establish the appropriate unit of measurement. |
| Policyholder accounting | Policyholder accounting (other than by cedants) will not be included in the Exposure Draft but will be included in the insurance accounting standard. |
| Presentation | Rejection of a model that recognises revenue on the basis of written premiums. Revenue will be recognised as the insurer performs under the contract).<br><br>The insurance contract will be presented as a net amount inclusive of all rights and obligations rather than separate asset and liability components. |
| Presentation | Performance statement presentation should include at least the following information:<br><br>• release of expected margin during the period;<br>• difference between actual and expected cash flows;<br>• changes in estimates; and<br>• results from investments (interest income and unwind of discount on the insurance liability).<br><br>Both the summarised margin and expanded margin approaches will be included in the Exposure Draft.<br><br>A traditional premium allocation approach may only be used for insurance contracts required to be measured under the unearned premium approach. |
| Policyholder behaviour | Expected cash flows from options, forwards and guarantees relating to the insurance coverage (e.g. renewal and cancellation options) are part of the contractual cash flows rather than a separate contract or part of a separate customer intangible asset. Measurement of these options will be based on a "look through" approach when reference to standalone price is not available.<br><br>All other options guarantees and forwards not relating to the existing insurance coverage will form part of a separate contract that will be accounted for according to the terms of that separate contract. |
| Deposit floor | The first building block will include all the cash flows arising from the cancellation or the renewal options, i.e. no deposit floor. |

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| Reinsurance | Reinsurers to use same measurement principles as for insurers.<br><br>Cedants should measure reinsurance assets using the same principles used to measure the reinsured liability. The Boards will consider further the accounting by cedants for residual margins and impairment of reinsurance contracts.<br><br>Reinsurance assets should not be offset against insurance liabilities unless the legal requirements are met.<br><br>Reinsurance should not result in derecognition of insurance liabilities unless the obligation has been discharged, cancelled or expired.<br><br>The cedant and reinsurer should account for ceding commissions on proportional reinsurance in same manner as the cedant's related acquisition costs. The Boards will consider further the anchoring of ceding commission to acquisition costs and accounting for ceding commission on non-proportional reinsurance contracts. |
| Disclosures | Three high level principles, supported by detailed requirements and guidance that will draw from existing guidance in IFRS 4 and US GAAP, will require an entity to disclose information that:<br>• explains the characteristics of its insurance contracts;<br>• identifies and explains the amounts in its financial statements arising from insurance contracts; and<br>• helps users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.<br><br>Although the staff recommends a number of disclosure requirements, the Boards were unable to agree to them and requested that the staff reconsiders the proposals in view of the comments made by the Board members. |
| Unbundling | The Staff has proposed a new principle for unbundling:<br>"A component of an insurance contract should be unbundled if it functions independently from other components of that contract. A component functions independently if it is not significantly interdependent with other components of that contract."<br><br>The Boards have not agreed yet to this principle and have asked the Staff to refine it further. If unbundling is not required for recognition and measurement, it should not be a permitted option.<br><br>For account-driven contracts, account balances that are explicit should be unbundled. The ED will ask the question as to whether all account balances, including those that are not explicit, should be unbundled. |
| Variable and unit linked contracts | The associated assets and liabilities should be reported as assets and liabilities of the insurer in the statement of financial position.<br><br>Consolidation of investment funds will be addressed in the consolidation project. |
| Risk Adjustment | If the measurement of an insurance contract is to include an explicit risk adjustment, it should be implemented by limiting the range of permitted techniques to measure such an adjustment. |

| Divergent tentative views | IASB | FASB |
|---|---|---|
| Measurement objective and approach, and risk adjustment | The building blocks are:<br>• the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation;<br>• the incorporation of the time value of money;<br>• an explicit, re-measured risk adjustment for the insurer's view of the effects of uncertainty about the amount and timing of future cash flows; and<br>• an amount that eliminates any gain at inception of the contract calibrated to the consideration receivable net of incremental acquisition costs.<br><br>Consistent with IAS 37, the risk adjustment, re-measured at each reporting date, is defined as the amount the insurer would rationally pay to be relieved of the risk. | The FASB does not support the recognition of a separate risk adjustment, and has returned to its pre-December 2009 position.<br><br>The FASB agrees with the IASB on the first two building blocks, but favours a composite margin rather than the risk adjustment and residual margin preferred by the IASB.<br><br>The composite margin contains both the IASB's risk adjustment for the insurer's view of the effects of uncertainty about the amount and timing of future cash flows and an amount that eliminates any gain at inception of the contract calibrated to the gross consideration receivable. |
| Acquisition costs accounting and revenue recognition | Expense all acquisition costs as incurred through profit or loss, offset by a release of revenue on day 1 equal to incremental acquisition costs. Direct measurement of the contract liability should be calibrated to the consideration receivable net of incremental acquisition costs;<br><br>OR<br><br>Expense non incremental acquisition costs as incurred. Incremental acquisition costs should be included in the contract cash flows to determine the residual margin at the inception of the contract. | Expense acquisition costs as incurred through profit or loss, with no release of revenue on day 1.<br><br>The initial contract liability is therefore calibrated to gross consideration receivable. |

■ Recent changes

| Divergent tentative views | IASB | FASB |
|---|---|---|
| Definition of significant insurance risk | The IASB favour a definition based on the variability of cash flows as currently included in IFRS 4, where the test should be on the range of possible outcomes and the significance of reasonably possible outcomes relative to the mean, i.e. the variability of outcomes should be significant. | The FASB, while agreeing on the variability of cash flows, believe that there should also be a test to identify a possible outcome, in which the present value of the net cash flows (premiums less claims/benefits) is negative, i.e. a contract loss test. |
| Insurance contracts with participation features | Cash flows from participation features should not be measured separately from the host insurance contract and they should be part of the overall expected cash flows of that contract. | Participation features should only be classed as liabilities when they meet the definition of a liability, particularly in relation to whether there is a legal or constructive obligation to pay. The remainder should be classified as equity. |
| Recognition | The IASB declined to make a final decision on recognising insurance contracts. The staff is to provide additional analysis at a later meeting. | An insurance obligation should be recognised at the earlier of (1) the entity being on risk and (2) the signing of the insurance contract |
| Derecognition | Derecognition of insurance liabilities should follow the IAS 39 criteria. | An insurance liability should be derecognized when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation. |
| Presentation | Performance statement presentation should follow the expanded margin approach, either based on the premium paid or the part of the premium paid for services. | Performance statement presentation should follow the summarised margin approach. |
| Unbundling of embedded derivatives | Embedded derivatives should be unbundled using exiting bifurcations requirements. | Embedded derivatives should be unbundled using the unbundling principle that is proposed for all other components of an insurance contract. |

| | IASB tentative decisions not yet discussed by FASB or to be discussed further by FASB |
|---|---|
| Discount rates | Principles based approach, based on liability characteristics (currency, duration and liquidity). |
| Exclusion of discounting and margins for some business | IASB considered this approach for certain non-life business and tentatively rejected it from the measurement candidates. |
| Unearned premium method | Requirement to use the unearned premium method to account for the pre-claim liability for all contracts which meet all of the following conditions:<br>• cover 12 months or less;<br>• no embedded options or guarantees; and<br>• the insurer is unlikely to become aware of events which could result in significant decreases in the expected cash outflows. |
| Other comprehensive income | IASB tentatively decided:<br>• not to change the current accounting for an insurer's assets; and<br>• not to permit or require the use of other comprehensive income for insurance contracts. |

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