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IFRS in Focus
Insurance Contracts

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The Bottom Line

- The proposed 'building block' approach for recognition of the insurance contract obligation is very different to the approaches and methods used today.
- There are three building blocks: a current probability-weighted estimate of the future cash flows, discount rate and a risk adjustment and a residual margin for uncertainty and future profits.
- Insurers will be required to develop their own approach to determine appropriate estimates for each of the building blocks.
- Incremental acquisition costs would be included in the cash flows arising from the contract.
- Increased earnings volatility could result where there is a mismatch in measurement of the liability and any linked or associated assets, for example, where the discount rate of the liability differs from the expected return on assets. The pattern of profit recognition will also be affected by the release of the risk adjustment and residual margin over the contract term.
- A loss could arise on initial recognition depending on how the insurance contract is priced.
- Requirements to 'unbundle' contracts where (1) the insurance coverage is combined as non-insurance obligations that are not closely related to it and (2) for which revenue recognition must be considered individually, could significantly affect the timing of revenue recognition.
- Significant system changes may be required to allow for the determination and tracking of the probability-weighted cash flows, relevant acquisition costs, the date of recognition (as defined under the ED) of the obligation, probability distribution models for portfolio measurement and the appropriate discount rate.

The proposals

On 30 July 2010, the International Accounting Standard Board (IASB) published Exposure Draft ED/2010/8 *Insurance Contracts* (the ED). This ED represents an important milestone in the Phase II of the IASB's project to revise fundamentally IFRS 4 *Insurance Contracts*.

A project on insurance contract accounting has been ongoing since 1997 and the ED of IFRS 4 Phase II finally proposes a consistent standard for all insurance and reinsurance contracts, both life and non-life. Since the US Financial Accounting Standards Board (FASB) joined the project in October 2008, the landscape of Phase II has been rapidly evolving into a key convergence project, with the result that the FASB will be publishing the IASB's ED in the coming weeks as a Discussion Paper to seek the views of US constituents on the proposed IFRS model.

The development of IFRS 4 Phase II has been highly controversial as it significantly changes the current accounting for insurance contracts due to the proposal for insurance liabilities to be measured on a current value basis with maximum use of market consistent inputs. The ED requires insurance liabilities to be measured using a transparent 'building blocks' accounting model based on a discounted probability-weighted estimate of future cash flows. The accounting for the volatility inherent in this probability-weighted estimate is an area that the IASB and FASB failed to agree upon during their deliberations, resulting in two different methods being proposed in the ED.

Measurement model

The ED proposes that all insurance contracts are accounted for by applying a measurement model that uses a transparent 'building block's approach. The three building blocks are described in the following sections.

Building block 1 – probability-weighted estimate of future cash flows

The first 'building block' is defined as a current, unbiased and probability-weighted estimate of the projected future cash flows expected to arise as the insurer fulfils the obligation under the insurance contract, i.e., an expected value. The contract period includes all cash flows until the point at which the insurer can unilaterally terminate or re-underwrite (reassess the risk of the particular policyholder and re-price it to reflect fully the risk of) the contract. This is known as the contract boundary and it represents an important and innovative feature of the proposals and is discussed in more detail below.

The insurance contract should be recognised initially at the earlier of the date when the insurer is bound by the terms of the insurance contract (usually the signing date) or when the insurer is first exposed to risk under the contract (the effective date of the contract); it is derecognised when it no longer qualifies as a liability of the insurer.

Observations

The initial recognition principle is aligned with existing IFRSs because the date the accounting for the contract would usually begin is when the contract is signed. In addition, consistent with the general IFRS concept of recognising a liability when an entity has an unavoidable obligation, the proposals would require a test to establish if the insurer has acted in such a way that it is "on risk" even prior to the contract being signed. For example, this could occur if an insurer makes a legally binding, irrevocable and unilateral promise to stand ready to pay claims.

Accounting for insurance contracts on this basis would require system changes in all those cases where the accounting systems have used the "risk inception date" to start the accounting processes. This approach has been particularly common among general insurers that underwrite property and casualty risks.

The process to estimate the future cash flows is not based on fair value concepts; instead it should reflect the insurer's own perspective and should cover all future cash flows that are integral to the fulfilment of the insurance contract on an expected value basis (i.e., probability-weighted). These cash flows would include premiums, expenses, benefits and claims payments as well as the incremental acquisition costs, and in the case of participating insurance contracts, the benefits that an insurer expects to pay to policyholders (i.e., policyholder dividends). Observable market data (for example, interest rates and other market data) should be considered in developing the estimates.

This method is referred to as the "current fulfilment value" approach because it focuses on the entity's fulfilment obligations.

Observations

Probability-weighted estimates would require the development of multiple scenarios, with each scenario assigned a specific probability based on an entity's estimate of the probability of that scenario occurring. While the ED does not require it, the stochastic modelling to capture multiple possible scenarios could be the most reliable approach to calculate an expected value. This method is not generally used in current insurance accounting models and may therefore require model and system adjustments.

A very important characteristic of the first 'building block' of the measurement model is that the cash flows include those acquisition costs that are directly attributable and incremental to the activities of selling, underwriting, and initiating individual insurance contracts that are actually sold contracts. The incremental acquisition costs should be identified for each individual contract, rather than for a portfolio of insurance contracts.

Acquisition costs that are not incremental acquisition costs of insurance contracts must be expensed as incurred.

Observations
The requirement to consider directly attributable and incremental acquisition costs in the first 'building block' means that issuing an insurance contract does not create an accounting loss on initial recognition. This is because, as acquisition costs are considered in pricing, the initial insurance contract liability will usually be lower than the consideration received (the first cash inflow from the contract, usually paid upfront).

The narrow definition of incremental acquisition costs and the role that these costs will play in the new model would require adjustments to the insurer's expense allocation systems.

Building block 2 – a discount rate to reflect time value of money

The ED requires discounting of the cash flows using the discount rate that reflects the characteristics of the insurance liability – i.e., its currency, duration and liquidity characteristics. The discount rate should not reflect the characteristics of the assets backing the liability, unless the amount, timing or uncertainty of the contract's cash flows depends on the performance of specific assets (e.g., participating contracts). The discount rate could be estimated using a risk free rate adjusted for an illiquidity premium. For example, a payout of an annuity results in highly illiquid cash flows because the policyholder cannot withdraw cash prior to each annuity payment being due or redeem the contract at will.

There is no widely accepted technique for determining an illiquidity premium. However, the ED includes disclosure requirements relating to the process of selecting material assumptions, including the method for selecting discount rates and the associated illiquidity premium, when applicable.

The present value of the fulfilment cash flows shall not reflect the risk of non-performance by the insurer, either at initial recognition or subsequently.

The approach to determining the appropriate discount rate is similar to that used in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for measuring provisions and IAS 39 *Financial Instruments: Recognition and Measurement* for measuring the fair value of financial instruments.

Observations
A number of existing non-IFRS accounting models use asset-based approaches to determining insurance liabilities' discount rates. For example, some accounting frameworks (e.g. US GAAP and Canadian GAAP) require the linking of the discount rate of an insurance liability to the assets that the insurer has purchased to back that liability irrespective of whether the insurance contract's cash flows are affected by the value of these assets. The proposals would not reflect the characteristics of the assets backing the liability, unless a clear link exists, i.e. the amount, timing or uncertainty of the contract's cash flows depends on the performance of specific assets (e.g., participating contracts). For non-participating contracts, all other things being equal, the ED may result in: an increase in the insurance liability on transition (and a related decrease in equity) and an increase in earnings volatility for any component of the assets' interest rates that cannot be reflected in the liability's discount rate. The degree to which this requirement will affect insurers will depend on an insurer's past practice and whether the insurance contracts have a particularly long duration. The potential earnings volatility will also depend on the extent to which the change in the value of the insurer's assets matches the changes in the insurance liabilities.

Systems and processes would need to be re-configured to introduce discounting of insurance contracts using the discount rate that reflects the characteristics of the insurance liability. Insurers would need to develop methodologies to determine the illiquidity premium, and as the IASB has not prescribed a methodology, there is bound to be a period of reduced comparability in financial reporting as practice evolves in this area.

Building block 3 – a margin to reflect uncertainty and future profits

The ED requests feedback on two different models on how to account for the volatility of insurance contracts' cash flows:

- The first model requires the uncertainty of the cash flows to be explicitly measured in a risk adjustment that insurers would calculate using one of three permitted techniques. Any accounting profit that would arise when the insurance contract is measured as the sum of the expected value and the risk adjustment is captured through a residual margin and recognised over the period of the insurance coverage.

- The alternative model avoids the explicit measurement of estimation uncertainty (i.e., the risk adjustment) and, instead, captures it together with any future profit in a "composite margin" which is subsequently released to profit using a formula based on the actual cash flows paid and received compared to their expected value.

The table below summarises the key areas and the differences under each approach.

	Risk Adjustment plus Residual Margin	Composite Margin
Margin components	Two components • Risk adjustment (explicitly reported): represents the maximum amount that an insurer would rationally pay to be relieved of the risk that the ultimate actual fulfilment cash flows exceed the expected cash flows. • Residual margin: eliminates any gain at inception, if applicable.	Single component • Composite margin: eliminates any gain at inception and captures the amount that the insurer charged the policyholder to accept the uncertainty of the insurance risk transferred under the contract.
Day one loss and calibration to eliminate accounting gains at inception	The residual margin is calibrated against the expected present value of the contract in order to eliminate accounting gains at contract inception. The expected value includes a risk adjustment. Any accounting loss is recognised immediately.	The composite margin is calibrated against the expected present value of the contract in order to eliminate accounting gains at contract inception. The expected value does not include a risk adjustment. Any accounting loss is recognised immediately.
Interest accretion	The residual margin will accrete interest at the same rate as that used to discount the expected value on initial recognition. The explicit risk adjustment will not accrete interest because it is remeasured fully and it includes the relevant time value of money adjustment within it.	The composite margin will not accrete interest.
Available techniques	There are three permitted techniques to determine the risk adjustment (confidence level, conditional tail expectation and cost of capital).	Not applicable.
Level of aggregation	• The risk adjustment should be determined in total for each portfolio of contracts defined as "a group of contracts that are subject to broadly similar risks and managed together as a single pool". • The residual margin should be determined at a level which combines contracts within a portfolio by similar date of inception of the contract and by similar coverage period (cohort level).	The composite margin should be determined at a level which combines contracts within a portfolio by similar date of inception of the contract and by similar coverage period (cohort level).
Subsequent treatment	• The risk adjustment should be re-measured at each reporting date. • The residual margin should not be remeasured other than for the accretion of interest. • The residual margin will be released to income in a systematic way over the period of the insurance coverage.	• The composite margin should not be remeasured. • The composite margin will be released over the combined coverage plus claims handling period based on the following formula: **(Premium allocated to current period + current period claims and benefits)/ (Total contract premium + Total claims and benefits)**

Observations
The inclusion of an explicit risk adjustment is a substantial change from most current accounting models for insurance contracts. While some existing models incorporate risk margins, the development of actuarial techniques for measuring the uncertainty in insurance liabilities is a complex and evolving area of practice. Choosing the appropriate valuation technique, defining the correct level of aggregation and calibrating the technique to the portfolios could be a challenge for entities to implement and maintain subsequently. Changes in profit recognition patterns could arise from these changes depending on how the margin is released over time.

Access to increasingly granular data could offer a competitive advantage to entities in defining optimal portfolio for aggregation which would maximise diversification benefits reducing both liabilities and volatility of earnings. Developing probability distribution models for insurance liabilities at the portfolio level, and developing adequate support for the assumptions used, will require a robust process.

If a composite margin model is eventually selected, the calibration and subsequent release of margins necessitates entities to link current information back to premium and other values either set at contract inception or updated at each reporting period.

Measurement model – Simplified approach for short-term contracts

The ED explains that the accounting for all insurance contracts could go through two phases as determined by the occurrence of the insured event: pre-claim and post-claim. In a pre-claim phase the accounting model estimates the impact of the "stand ready" obligation on the insurer's performance. For contracts where a claim is notified, the measurement model calculates the post-claim liability, releasing the full residual margin to income and accounting for the liability using the 'building blocks' approach.

Due to the significant number of contracts that will have similar accounting movements in the pre-claim liability phase, the ED requires the use of a shortcut method for all contracts that have a coverage period of 12 months or less and that do not embed any options or additional guarantees. The ED notes that this simplified approach is developed as a shortcut of the main model and does not represent an alternative basis of accounting for insurance contracts.

The simplified approach requires the initial liability to be measured using the present value of the premiums expected from the contract (usually these are all paid upfront) less the amount of directly attributable and incremental acquisition costs (also usually all paid upfront). This liability is subsequently released through income based on the passage of time (i.e., on a straight line basis) unless the release based on the incurred claims and benefits is significantly different from a straight line basis. The release of the initial pre-claim liability through income aligns the profit pattern under this method to the main model: in both cases the profit is earned over the coverage period (12 months or less) with the same claim liability being recognised in the financial statements at the end of the coverage period.

The post-claim liability would always be measured using the three building blocks and insurers that are required to use the simplified approach will build in parallel a claim liability.

Observations
The simplified approach would apply to all contracts that provide short-term coverage and have simple terms. An analysis of usage of the unearned premium would be disclosed and would highlight the extent of compliance with the new requirements. Judgement would be required to determine and model an appropriate earnings pattern.

Contract boundary

A difficult conceptual issue that the ED has attempted to resolve is the reconciliation of the proposals with the definitions of an asset and liability in the Framework.

If an insurance contract's rights and obligations were required to be analysed separately, the obligation to pay claims would be considered unconditional and would need to be recognised in full whilst the rights to receive premiums from the policyholder would be recognised as an asset only to the extent the right to receive them is enforceable. This approach could produce a significant liability that would be inconsistent with underlying economics.

Recognising this problem, the IASB has instead adopted an approach that considers the contract as a bundle of rights and obligations inclusive of embedded options that allow policyholders to cancel or renew the contract.

The IASB believes that embedded options for cancellation and renewal are integral to the contract and that the model must include their effect in the measurement of the first building block. The time period over which options are considered is limited to the boundary of the insurance contract. This is a point in time in the future either when the insurer is able to cancel or decline the offer of insurance coverage to the policyholder or when it has "the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk".

The recently issued revenue recognition exposure draft applies the same concept of taking into account the existence of options in allocating consideration to different elements in a contract. The wider application of this concept in the IFRS revenue model would make this assessment relevant to non-insurance services sold (e.g. asset management services).

Observations

The simplified approach would apply to all contracts that provide short-term coverage and have simple terms. An analysis of usage of the unearned premium would be disclosed and would highlight the extent of compliance with the new requirements. Judgement would be required to determine and model an appropriate earnings pattern.

Another important effect of the contract-based approach is that the ED requires a single accounting balance to be presented that would display the bundle of rights and obligations at the reporting date.

This approach ties with the estimate of future net cash flows used in the building blocks approach. It also means that there could be situations where the net expected value reflects an asset before becoming a liability (e.g. for long-term regular premium contracts where most inflows are paid in future instalments).

Participating features

The contract based model introduced in the ED enables the IASB to resolve another particularly difficult issue: the accounting for participating features.

Insurers frequently offer to their policyholders the option to receive significant supplemental benefits in addition to guaranteed benefits. These supplemental benefits are determined by the insurer on a discretionary basis. However, according to the ED, to meet the definition of a participating feature the reference amount must be based on:

"(i) the performance of a specified pool of insurance contracts or a specified type of insurance contract; or

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the company, fund or other entity that issues the contract."

Currently, insurers can decide to treat the participating features as a liability, an equity component or to split it between the two classifications.

The ED concludes that participating features are so interdependent with the other clauses of the contract that they should be treated as an integral component of the contract and thus be included in the estimation of the future cash flows which the insurer will pay to its policyholders, i.e., the insurers will need to estimate the extent of the award that they would reasonably expect to add to the guaranteed benefits under the contract.

The ED also acknowledges that participating features are embedded both in insurance contracts and in financial instruments that do not transfer insurance risk. All financial instruments with participating features defined as above are scoped into the ED for insurance contracts rather than IAS 39 *Financial Instruments: Recognition and Measurement.* This scope decision is consistent with the current approach used under IFRS 4.

Under US GAAP, the FASB decided to apply the general financial instruments accounting model to these types of financial instruments.

Observations
The proposed solution to the accounting for participating features would apply in an area where current practices differ significantly.

The ED's approach would bring consistency but it would also introduce what could be one of the most significant implementation challenges at the transition date, particularly for life insurers. The approach would require an analysis of the surplus arising from participating funds reflected in the statement of financial position of insurance companies (known in certain jurisdictions as the "inherited estate") in terms of the expected distribution to policyholders and shareholders. The allocation of the surplus to the policyholders will be included as part of the insurance contract liability whilst the allocation to the shareholders will affect the insurer's equity. Considering the large and stratified surpluses that certain participating funds carry due to their long history (some date back to the 19th century), insurers would need to start the analysis under the new requirements at the earliest opportunity. A timely analysis will be important in understanding the outcomes of transition and the subsequent accounting as well as to manage a potential "windfall" to shareholders' retained earnings if the entire participating surplus is currently classified as a liability.

The ED also includes the following requirements for participating insurance and investment contracts:

- the requirement to use an asset-based discount rate;
- the application of the contract boundary to cancellation and renewal options embedded in participating financial instruments; and
- the requirement to earn the residual margin of participating financial instruments on a basis reflecting the value of the assets managed within the participating fund.

Definition and scope

IFRS 4 Phase I focused on the introduction of a workable definition of insurance contracts such that it was clear to investors what types of transactions would benefit from the grandfathering of past national accounting practices under IFRS. This definition proved to be effective and, therefore, the ED introduces only two limited refinements.

The first introduces the requirement to use present values to assess whether insurance risk is significant. This practice was already applied for insurance contracts where the insured event was the survival of the policyholder because the comparison of the benefits due on survival with other benefits due at other times (e.g. the policy surrender value) could only be done using the present value of the benefits due at the survival date.

The second relates to the requirement that the scenarios considered in assessing whether the insurance risk is significant have commercial substance. To have commercial substance, the scenario must be capable of producing a loss for the insurer after considering all the inflows it may receive from the contract.

Both these clarifications have been added to facilitate the FASB's move to adopt the IFRS contract definition.

The ED also contains a couple of important scope changes:

1. Issued financial guarantee contracts. These contracts have always met the definition of insurance contracts, but are currently accounted for under IAS 39 *Financial Instruments: Recognition and Measurement.* The ED proposes to account for issued financial guarantees as insurance contracts. The accounting for insurance contracts held is not addressed and, therefore, the holders of these guarantees would continue to account for them following their current accounting policy; and

2. Fixed fee service contracts. These contracts are currently in the scope of IFRS 4, but under the proposals they would be included in the scope of the new revenue recognition standard.

Unbundling

In developing IFRS 4 Phase I, there was significant debate about unbundling. The compromise reached at that time was to provide fairly limited guidance which required unbundling only if the insurer could measure the deposit component separately and its accounting policies did not otherwise require the insurer to recognise all obligations and rights from the deposit component. In practice, these conditions are rarely found and, therefore, mandatory unbundling occurs infrequently.

The ED requires unbundling of a component when it is not "closely related" to the insurance coverage. Therefore, the ED proposes unbundling of investment and service components from the insurance component and lists the following common examples:

(a) an investment component reflecting an account balance that meets specified criteria;

(b) an embedded derivative that is separated from its host in accordance with IAS 39 Financial Instruments: Recognition and Measurement; and

(c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

The ED clarifies that, under (a) above, only the pure deposit has to be unbundled, with all fees and charges associated with it treated as belonging to the insurance component or another component of the bundled contract.

Another helpful clarification comes for embedded surrender options and why they would not normally be bifurcated from the host insurance contract. The ED explains that because surrender options usually determine the cancellation of the whole contract, they are interdependent with all the other components and thus are closely related to the insurance coverage.

Observations

There are significant implications for the life insurance industry that range from separately accounting for account values in annuity products and universal life products to the bifurcation of embedded derivative guarantee products. The unbundling principle operates within the definition of an insurance contract, thus the ultimate determination of the features of each component will need to be made on an individual product basis.

Presentation

Besides developing the measurement approach for insurance contracts, the ED requires that an insurance contract should be presented in the statement of comprehensive income under the "summarised margin" approach.

Due to the importance of the presentation of the statement of comprehensive income, the ED asks respondents to provide specific input on this issue. The face of the statement of comprehensive income would include, as a minimum, five line items.

- **Underwriting margin** – includes the earnings from the release of the residual margin over the coverage period and the earnings from the release of the risk adjustment, including the changes in the risk adjustment associated with the re-measurement of the expected value at the reporting date. Under the composite margin model this line will also include its release to income.

- **Gains and losses on initial recognition** – captures the day one losses recognised when the building blocks model produces a negative residual margin as well as the day one gains on purchasing reinsurance (see below).

- **Non-incremental acquisition expenses**

- **Experience adjustments and changes in estimate** – includes the differences between expected and actual cash flows, the changes in estimates of future cash flows, changes in the discount rate used to discount them and impairment losses on reinsurance assets.

- **Interest expense on the insurance liabilities** – unwinding of the discount, preferably together with the results from investments backing insurance liabilities.

Specific additional lines will be required when the simplified method is used to present the earnings from the unearned premium liability separately from the expenses from the claims liability calculated with the three building blocks. For each of the line items, the components required to be presented could be included as separate line items or disclosed in the notes.

The objective of this presentation approach is to display on the face of the statement of comprehensive income the key components of the building blocks model that underpins the profit recognition.

Observations
The summarised margin approach is relatively new to IFRSs and several accounting practices exist where a "gross flows" presentation is used, displaying as revenues and expenses the contract's inflows and outflows, respectively. The supplementary reporting known as "embedded value" adopts a similar approach to display a life insurer's performance. However, this approach is uncommon among general insurers.

The codification of general ledgers and underlying accounting systems would need to accommodate the new presentation requirements, and the implementation of the necessary processes to capture the required data could be challenging if left to a later phase of implementation plans.

Disclosure

The proposed disclosure principles intend to help users of financial statements understand the amount, timing and uncertainty of future cash flows arising from insurance contracts. The principles set out in the ED note that an entity shall disclose qualitative and quantitative information about:

- the amounts recognised in its financial statements arising from insurance contracts; and

- the nature and extent of risks arising from those contacts.

The ED also states that the maximum level of aggregation for disclosure purposes is the reportable operating segment as defined under IFRS 8 *Operating Segments.* It also requires that the disclosures are sufficient to allow the figures to be reconciled to the items presented on the face of the financial statements.

Unlike the requirements of IFRS 4 Phase I, the ED is fairly prescriptive on the format the disclosures should have. For example, the ED explains in detail the individual line items that should be included in the roll forward tables that explain the movement of insurance contract carrying amounts. These roll forward tables would have to be structured to indicate the movements in each of the building blocks.

The ED requires disclosure of the methods and inputs used to estimate the risk adjustment, and where appropriate, the confidence level to which the risk adjustment corresponds.

The ED maintains the current requirement to produce loss development tables of post-claim liabilities to a maximum of ten years. The proposed transitional rules would limit the historical information in the loss development table to an initial period of five years, if earlier information was not previously published. In effect, this would allow an insurer to build up the additional five year history over time. However, this transitional relief of a gradual increase to a ten-year loss development table would not be available to existing IFRS reporters which have already been complying with this disclosure requirement under IFRS 4 Phase I since 2005 as they will have already published loss development tables going back to 2000.

Observations
The ED would not significantly change the disclosure requirements from IFRS 4 Phase I. However, the ED requires a more significant level of disclosure than historically required under local country GAAP. This added level of disclosure will require insurers to reassess the way that they capture and manage data, their systems capabilities and the appropriateness of internal controls over financial reporting.

Unit-linked contracts

The ED would extend the list of items that can be considered under the fair value option to include own shares and owner-occupied properties when held in funds backing unit-linked contracts.

These exceptions to the general IFRS principles in IAS 32 *Financial Instruments: Presentation and* IAS 16 *Property, Plant and Equipment* allow the elimination of certain accounting mismatches that were created under the IFRS 4 Phase I regime. The exception for own shares is particularly notable as these instruments currently cannot be recognised as assets (they are accounted for as a deduction from equity). Under the proposals, if own shares are placed in a unit-linked fund, the issuer would have the option to treat them as assets and to recognise fair value gains and losses through income.

The ED introduces unit-linked presentation requirements focused on the "single line" approach that is commonly used under US and Canadian GAAPs. This requirement puts all of the assets backing unit-linked contracts within a single line item on the statement of financial position. A similar treatment applies to the statement of comprehensive income where a single income or expense line is required.

Observations
These provisions apply to both insurance contracts and financial instruments that have a unit-linking feature.

A continuing area of accounting mismatch that the ED does not resolve arises from the unit-linked fund investing in a subsidiary of an issuer. In this case, the fair value option will apply to the consolidated assets and liabilities. However, it would not apply to internally generated goodwill as it continues to be an asset for which recognition is prohibited under IFRS.

Reinsurance

Reinsurance purchased is the only type of policyholder accounting that the ED addresses.

The overall approach is the same as that described for insurance contracts, i.e., the three building blocks approach. However there are three specific requirements that need a separate analysis:

1. a cedant, an insurer that buys insurance against insurance risks it has accepted, measures the benefits from a reinsurance contract it has purchased with reference to the underlying reinsured risks and cash flows (the riskier the portion of cash flows that the cedant has reinsured, the greater the reinsurance asset);

2. if a cedant pays for the reinsurance contract an amount that is smaller than the asset it has recognised in its financial statements, that difference will be recognised immediately as a gain in profit or loss. In contrast, if the amount paid exceeds the asset recognised, the difference will represent a ceded residual margin which will be amortised and recognised in profit or loss over the period of reinsurance coverage; and

3. in addition to the measurement required under the building blocks model, a cedant must include an adjustment for the expected losses that will arise from the reinsurer's non-performance.

Transition and effective date

The ED is open for comments until 30 November 2010 with the final standard expected to be published in June 2011. The IASB is expected to issue a separate consultation document later this year seeking stakeholder input about effective dates and transition methods on a range of projects. It is expected that the effective date would be aligned with the mandatory application of IFRS 9 *Financial Instruments* (currently 1 January 2013). The Board will consider delaying the effective date of IFRS 9 if the IFRS on insurance contracts has a mandatory effective date later than 1 January 2013.

At transition, insurers would need to restate their insurance contract liabilities through a series of adjustments that include:

- write-off to opening retained earnings of all insurance intangible assets such as deferred acquisition costs or intangible assets recognised on acquisition of insurance businesses and portfolios; and

- restate all of the in-force insurance contracts using the building blocks approach. Any positive or negative difference arising from this restatement would need to be recognised in opening retained earnings. No residual margin would be recognised on transition.

Similar to the transitional provisions of IFRS 4 Phase I, the ED contains an option to reclassify financial assets to the fair value through profit or loss category on adoption of the new IFRS. No reclassification to other measurement categories would be permitted.

The transitional provisions apply to both existing IFRS reporting entities and first time adopters.

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