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IFRS Project Insights

Insurance Contracts

26 October 2011

The IASB and FASB (the "Boards") are undertaking a comprehensive project on the accounting for insurance contracts. The Boards' objective is to develop a common, high-quality standard that will address recognition, measurement, presentation, and disclosure requirements for insurance contracts.

The IASB issued the Discussion Paper *Preliminary Views on Insurance Contracts* in May 2007. On 31 July 2010, the IASB issued ED/2010/08 *Insurance Contracts* (ED). The comment period ended on 30 November 2010. In February 2011, the Boards began their redeliberations of the proposals in the ED.

Tentative Decisions Reached during Redeliberations

The following summarises the Boards' tentative decisions to date:

Assumptions for the insurance project

The Boards decided on the following assumptions under which the *Insurance Contracts* project is being developed:

- that the development of a standard for insurance contracts is appropriate;
- the standard will address the accounting for insurance contracts from the perspective of the insurer, and not for the assets backing the contracts or for entities that issue those contracts;
- insurance contracts will be considered as a bundle of rights and obligations generating a package of cash flows;
- insurance contracts will generally be measured at the portfolio level;
- the model should be based on current estimates;
- the cash flows incorporated into the measurement of the liability are those that arise as the insurer fulfils the insurance contract;
- the model will use the expected value of future cash flows; and
- the liability will not reflect an insurer's own credit standing.

Scope

The Boards tentatively decided to exclude from the scope of the insurance contracts standard fixed-fee service contracts that provide service as their primary purpose if they meet all the following criteria:

- the contracts are not priced on the basis of an assessment of the risk associated with an individual customer.
- the contracts compensate customers by providing a benefit in kind (i.e., service) rather than cash payment.
- the type of risk transferred by the contracts primarily relates to utilisation (or frequency) of services relative to the overall risk transferred.

The Boards also tentatively decided on the following scope exclusions that were proposed in the ED:

- product warranties issued by a manufacturer, dealer or retailer;
- employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item;

- residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease;
- contingent consideration payable or receivable in a business combination; and
- direct insurance contracts that the entity holds (i.e., direct insurance contracts in which the entity is the policyholder).

Eligibility criteria for the premium allocation approach

In its October 2011 meeting, the Boards discussed when insurers should apply the premium allocation approach proposed in the ED (‘one-model’ approach). However, no tentative decisions were reached as a result of these discussions.

Discount rate for non-participating contracts

The Boards tentatively decided that the objective of the discount rate is to adjust the future cash flows for the time-value of money and reflect the characteristics of the insurance contract liability. The Boards tentatively decided that a model would not be prescribed for the calculation of the discount rate. Insurers would be permitted to use any methodology provided the resulting discount rate (1) is consistent with observable current market prices, (2) excludes any factors that influence that observed rates but that are not relevant to the insurance contract liability and (3) reflects only the affect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

The Boards discussed whether to allow the use of a specified rate (e.g., one based on the interest rate of a high quality corporate bond) as a practical expedient to allow insurers to determine their discount rate in certain circumstances. The Boards acknowledged that a proxy rate might be a useful approach, but before taking any decision, instructed the staffs to perform further research which will be discussed at a future meeting.

Estimation of cash flows

The Boards tentatively decided that the measurement objective should be based on a mathematical mean that considers all relevant information and that a sufficient number of, rather than all, scenarios should be considered by the insurers.

The Boards also tentatively decided:

- to clarify that all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to determine the insurance liability, including:
  - costs that relate directly to the fulfilment of the contracts in the portfolio, such as payments to policyholders, claims handling, etc.
  - costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and
  - such other costs as are specifically chargeable to the policyholder under the terms of the contract.
- to confirm that costs that do not relate directly to the insurance contracts or contract activities should be recognised as expenses as incurred;
- to provide application guidance based on IAS 2 *Inventories* and IAS 11 *Construction Contracts*; and
- to eliminate the term 'incremental' from the discussion of fulfilment cash flows that was proposed in the ED.

Measurement of policyholder participation

The Boards discussed how to apply the principle that an insurance contract is measured using the expected present value of the fulfilment cash flows when those cash flows result from contractual participation features and the cash flows have a dependency from asset values held in participating funds. The IASB tentatively supported the following staff recommendations:

- The cash flows expected to result from the policyholder participation should be included in the insurance liability on the same basis as the measurement of the underlying items in which the policyholder participates, in which such items could be assets and liabilities, the performance of an underlying pool of insurance contracts or the performance of the entity;
- The measurement of the participating contract should reflect the asymmetric risk sharing between the insurer and the policyholder resulting from the minimum guarantee;
- The changes in the insurance contract liability reflected in the statement of other comprehensive income should be consistent with the presentation of the changes in the items from which the participating liability depends on; and
- The same measurement approach should apply to unit-linked ("UL") and participating contracts ("par").

The IASB staff will continue to explore whether tentative decisions outlined above provide for the need for any specific disclosures.

FASB was more aligned with the ED proposals rather than with the staff recommendations. The FASB noted that they would prefer to value the liability using the building block approach (i.e., project cash flows based on the contractual obligations of the insurer and use the fair value of the underlying items if that is what affects the benefits payable to the policyholder). They acknowledged that this creates an accounting mismatch in the situation where the underlying item is measured on a different basis or it is not recognised at all. They referred to this approach as a two-step approach with the mismatch being addressed in a second step which could produce some amendments to the accounting treatment of the assets.

Risk adjustments

The IASB tentatively decided that the measurement of an insurance contract should contain an explicit risk adjustment that would be determined separately from the premium and re-measured during each reporting period.

The FASB tentatively decided that the measurement of an insurance contract should use a single margin approach that recognises profit as the insurer satisfies its performance obligation (as it is released from exposure to risk). An insurer would not remeasure or recalibrate the single margin to recapture previously recognised margin. The FASB would consider the inclusion of an onerous contract test as part of the model.

The IASB and FASB will continue to explore whether the two approaches could be made comparable through disclosures.

Risk adjustment: Objective and confidence level disclosure

The IASB tentatively decided that the objective of risk adjustment should be the 'compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract'; and that the application guidance should clarify that:

- the risk adjustment measures the compensation that the insurer would require to make it indifferent between fulfilling an insurance contract liability that would have a range of possible outcomes or fulfilling a fixed liability that has the same expected present value of cash flows as the insurance contract. For example, an insurer would measure the risk adjustment by determining the compensation required to make it indifferent between fulfilling a liability that is 50% likely of being 90 and 50% likely of being 110, or fulfilling a liability of 100.
- an insurer should consider both favourable and unfavourable outcomes in a way that reflects its degree of risk aversion in estimating the risk adjustment. For example, a risk-averse insurer would place more weight on unfavourable outcomes than on favourable ones.

The IASB tentatively decided to retain the confidence level equivalent disclosure whereby an insurer would be required to disclose the confidence level that results in the same risk adjustment liability calculated using the selected valuation technique.

Explicit risk adjustment

The Boards tentatively decided that if there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment in the measurement of those liabilities would provide relevant information to users.

Risk adjustment: Techniques and inputs

The IASB tentatively decided not to limit the range of available techniques and the related inputs to estimate the risk adjustment. Instead it decided to retain only the list of characteristics, as proposed in paragraph of B72 of the ED, that a risk adjustment valuation technique should exhibit if that technique is to meet the objective of the risk adjustment.

The IASB also tentatively decided to retain as examples the three techniques proposed in the ED (confidence levels, conditional tail expectation and cost of capital), together with the related application guidance.

Residual margin

The IASB tentatively decided not to lock earning pattern of the residual margin at inception. That is, the residual margin should not be released to income on a systematic and rational basis that is independent of the remeasurement of the insurance liabilities. Instead, it will be adjusted for both favourable and unfavourable changes of the insurance liabilities. The FASB indicated it would not favour unlocking the residual margin after inception if the FASB were to adopt an approach that includes both a risk adjustment and a residual margin as opposed to their preferred single composite margin approach.

In unlocking the residual margin, the IASB tentatively decided an insurer should:

- adjust the residual margin for both favourable and unfavourable changes in the estimates of future cash flows used to measure the initial liability, with experience adjustments recognised in profit or loss;
- not limit changes in the residual margin;
- prospectively apply adjustments to the residual margin; and
- always recognise changes in the risk adjustment in profit or loss in the period of change without impacting the residual margin.

The FASB did not discuss this topic given their preference for a single composite margin, as outlined above.

In parallel with unlocking of the residual margin, an allocation of the same should take place and the IASB tentatively decided that:

- insurers should allocate the residual margin over the coverage period on a systematic basis that is consistent with the contractual pattern of transfer of services provided; and
- the residual margin should not be negative.

Day one gains and losses

The Boards tentatively affirmed that an insurer would not recognise accounting day one gains on issuing insurance contracts, would be required to recognise any day one losses and the residual or composite margin could not become negative on subsequent measurement.

Acquisition costs

The Boards tentatively decided that acquisition costs to be included in the initial measurement of a portfolio of insurance contracts would be limited to direct acquisition costs. Indirect costs would not be included in initial measurement.

The Boards remained split on the question of whether to restrict acquisition costs in initial measurement to those related to successful efforts, with the FASB unanimously supporting limiting the recognition of acquisition costs to successful efforts, whilst the IASB remained supportive of no distinction between successful and unsuccessful acquisition efforts.

Financial guarantee contracts

The Boards tentatively decided the following:

- financial guarantee contracts would be scoped out of the IFRS for insurance contracts and into the IFRS for financial instruments. However, the IFRS for insurance contracts would:
    - permit an issuer of a financial guarantee contract (as defined in IFRSs) to account for the contract as an insurance contract if it had previously asserted that it regards the contract as an insurance contract; and
    - require an issuer to account for a financial guarantee contract (as defined in IFRSs) in accordance with the financial instruments standard in all other cases. Such contracts would be measured initially at fair value (typically equal to the consideration received), with subsequent amortisation of that amount, coupled with a test for credit losses under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- not to provide an exception in the preparation of standalone financial statements for the treatment of intergroup guarantees from the accounting required for financial guarantee contracts.

The Boards agreed to complete the insurance contracts project as planned, complete their deliberations on the impairment of financial assets project and then begin a joint project to develop a converged solution for financial guarantee contracts including those issued by members of the same group.

Locking in the discount rate

The Boards agreed that the discount rate should remain “unlocked” which is consistent with the proposal in the ED.

Discounting non-life contract liabilities

The Boards discussed whether short-duration, non-life insurance contracts should be exempted from discounting in response to concerns raised by respondents (primarily property/casualty insurers in the US) that the application of discounting to short-term non-life insurance contracts would not faithfully represent those contracts. The Boards were unable to reach consensus on this issue and instructed the staff to investigate further and to bring this issue back as part of the consideration of the modified approach for short-duration contracts.

The Boards tentatively decided that an entity should discount to long-tail claims with a reasonably determinable payout pattern and long-tail claims when the amount and timing of cash flows is uncertain.

Approaches to calculating the discount rate

The Boards tentatively decided that the following application guidance should be provided in the final standard relating to the calculation of the discount rate:

- The top-down discount rate is not an asset rate, but should be determined to reflect the characteristics of the insurance contract liability.
- An appropriate yield curve should be determined based on current market information and can reflect the actual assets that the insurer holds, or be based on a reference (not replicating) portfolio which is determined to reflect the characteristics of the liability.
- If there are no observable market prices for points on the yield curve, the insurer should use an estimate consistent with the Boards’ guidance on estimates – particularly the guidance on Level 3 financial instrument fair value guidance.

The Boards tentatively decided that asset cash flows utilised for a top-down discount rate valuation should be adjusted to reflect the characteristics of the cash flows relating to the liability. In particular, the cash flows should be adjusted for:

- differences between the timing of the cash flows in the reference asset portfolio (or the insurer's own assets) and those of the liability to reflect the actual degree the durations match; and
- risks inherent to the assets but which do not relate to the liability.

The Boards tentatively decided that, as insurers using a top-down approach for determining the discount rate are likely to find it impractical to apply a bottom-up approach, no further adjustments to the discount rate would be required (e.g., liquidity / illiquidity).

Practical expedient for the discount rate

The Boards considered whether a proxy rate (e.g., an interest rate of a high quality corporate bond) could be used under certain circumstances as a practical expedient. The Boards tentatively decided that such an expedient should not be introduced in the final IFRS because it would not allow the achievement of the stated objectives of a discount rate that reflects the characteristics of the insurance contract cash flows. However, the FASB reserved their right to reconsider their decision when the scope of the new US accounting standard will be debated because the expedient may be useful if the scope requires a large number of non-financial institutions to be under the scope of the new standard for insurance contracts.

Discount rate for participating contracts

The Boards tentatively decided:

- to align the objectives for discount rates on participating contracts to those for non-participating contracts; and
- to include guidance in the final IFRS that explains how an insurer should reflect the dependency on asset values of participating contract cash flows.

Discounting for ultra long duration cash flows

The Board discussed considerations that need to be addressed when using discount rates for ultra long duration cash flows. The Boards tentatively decided that they were not in favour of this separate guidance being developed for the final IFRS or US GAAP standard.

Timing of initial recognition of an insurance contract

The Boards tentatively decided that insurance contract assets and liabilities should initially be recognised when the coverage period begins, but require the recognition of an onerous contract portfolio liability in the pre-coverage period if management becomes aware of an event that would cause a portfolio of contracts to become onerous in the pre-coverage period.

Definition of an insurance contract

The Boards tentatively decided to confirm the following additional conditions as proposed in the ED:

- In determining whether it will pay significant additional benefits in a particular scenario, the insurer takes into effect of the time value of money; and
- A contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insure can exceed the present value of the premiums.

Unbundling: Overall considerations

The Boards discussed the objectives in unbundling components from an insurance contract and how those objectives would be applied to determine what should be separated. The Boards tentatively agreed but did not make a formal decision that the objective for unbundling should be principles based and that differences in (1) measurement, (2) presentation, and (3) risk are the factors that need to be weighed in making such determination to unbundle. The Boards will discuss this topic in more detail at a future meeting.

Bifurcation of embedded derivatives

The Boards discussed whether the current requirements should be carried forward for the separation of embedded derivatives from host contracts. The Boards tentatively decided that embedded derivatives that are currently separated should continue to be separated for insurance contracts.

Contract boundaries

The Boards tentatively decided that a contract renewal would be treated as a new contract when (1) the insurer is no longer required to provide coverage or (2) the existing contract does not confer on the policyholder any substantive rights.

In determining the level at which the contract boundary is determined, the Boards tentatively decided that an insurer would be required to make that determination at the portfolio level but only if the pricing does not include risks relating to future periods.

The Boards tentatively decided that all renewal rights should be considered in determining the contract boundary, whether arising from contract, law, or regulation.

Short-term insurance contracts

Eligibility for the short-term contracts simplified accounting approach and its conceptual justification

The ED would require that all the short-term insurance contracts are accounted for using a simplified approach prior to any claims being incurred. Beyond the coverage period, the claim liability arising from the short-term insurance contracts would be accounted for using the main building blocks model.

The Boards discussed the conceptual justification of any simplifications to the building block approach for short duration contracts and whether it would constitute a proxy of the building block approach using a simplified version of the premium allocation approach proposed in the ED or whether it would be a more faithful representation of the underlying economics if the simplification was developed as a separate and distinct model ('two-model' approach).

The Boards have yet to discuss the detailed characteristics of the two models. However, under the 'one-model' approach, pre-claims liabilities would be measured by allocating premiums over the coverage period of the contract, with recognition of deferred incremental acquisition costs in a pattern consistent with the pattern in which the premium is recognised as revenue. Under the 'two-model' approach, short- and long-duration contracts would be indicative of two unique contract types requiring separate and unique accounting models. An insurer would include in the measurement of the liability the premium received at initial recognition, plus the undiscounted amount of expected future premiums that are within the boundary of the existing contract, less the direct acquisition costs incurred in securing the contract.

The Boards did not reach a tentative decision in how to justify the model definition and the associated eligibility criteria, nor did they discuss the characteristics of either model in detail. The Boards directed the staffs to prepare further analysis of both models, including differentiating contracts yielding incompatible eligibility results under the 'one-model' and 'two-model' eligibility criteria (i.e., contracts meeting the eligibility criteria under one of the above approaches but not the other) for discussion at a future meeting.

The only statement that the Boards agreed upon to date is that they intend to have a simplified approach based on the unearned premium.

Discounting of the pre-claims obligation

The Boards discussed whether the measurement of the pre-claims obligation at initial recognition should include the premium, if any, received at initial recognition, plus the undiscounted value of future premiums. The Boards did not reach a tentative decision.

Treatment of acquisition costs

The ED would require that an insurer would deduct the amount of acquisition costs from the pre-claims obligation measurement. The same principle was retained for the modified approach. The IASB supported retaining the ED's principle in line with the building blocks approach and to use a single definition of "contract acquisition cost" based on costs that directly relate to the contract acquisition activity – on a portfolio basis. The FASB did not support the proposal and noted that there was an opportunity for the new insurance standard to align the short-term insurance contracts accounting with the Revenue Recognition project. The IASB tentatively decided that an insurer should deduct from the pre-claims obligation measurement the acquisition costs that would be included in the measurement of the insurance contract liability under the building block approach. The FASB did not vote on this issue. The staffs will bring this issue back to the Boards at a future meeting.

Premium allocation patterns

The Boards tentatively decided that the pre-claims obligation should be reduced to reflect satisfaction of the performance obligation to provide coverage. The insurer would reduce the measurement of the pre-claims obligations over the coverage period as follows: (1) on the basis of time, but (2) on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

Onerous contract test

The Boards tentatively decided that an insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period. Indicators that were presented as "qualitative factors" included deteriorations in the combined ratio beyond 100% or the increase in the severity and/or frequency of the insured events.

Unbundling non-insurance goods and services

The Boards discussed whether non-insurance goods and services should be unbundled from an insurance contract in accordance with the principles for identifying separate performance obligations in the revenue recognition project as follows:

a. An entity should account for a bundle of promised good or services as one performance obligation if the entity integrates those goods or services into a single item that the entity provides to the customer. (If yes, do not consider criteria b).
b. An entity should account for a promised good or service as a separate performance obligation if:
    i. the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and
    ii. the good or service has a distinct function. A good or service has a distinct function if either: the entity regularly sells the good or service separately, or the customer can use the good or service either on its own or together with resources that are readily available to the customer.

The Boards indicated that they still need to consider whether the pattern of transfer criterion is necessary as well as consider future decisions on allocation. The Boards will gather feedback from the Insurance Working Group.

Unbundling an investment component

The Boards tentatively decided that an insurer should unbundle explicit account balances that are credited with an explicit return that is based on the account balance and such an explicit account balance should be separated from an insurance contract using criteria based on those being developed in the revenue recognition project for identifying separate performance obligations. An insurer would not unbundle implicit account balances.

The Boards will consider at a future meeting whether an explicit account balance exists only when the policyholder can withdraw the account balance without loss of insurance coverage.

The IASB tentatively decided that an insurer would account for an unbundled explicit account balance in accordance with the financial instruments requirements, subject to future decisions on allocation. The FASB did not vote on this issue. The Boards requested the staff to consider how the tentative decisions would apply to typical types of insurance contracts with account balances.

Reinsurance

The Boards tentatively decided:

- in clarifying the definition of reinsurance contracts, if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer (i.e., if the economic benefit to the reinsurer for its respective portion of the underlying policies is virtually the same as the ceding company's economic benefit), the reinsurance contract is deemed to transfer significant insurance risk.
- the insurer would assess the significance of insurance risk contract by contract. Contracts entered into simultaneously with a single counterparty *for the same risk*, or contracts that are otherwise interdependent, would be considered a single contract.
- a cedant would recognise a reinsurance contract using an estimate of the present value of the fulfilment cash flow for the reinsurance contract, including the ceded premium but without reference to the residual / composite margin on the underlying contracts. The cedant would estimate the present value of fulfilment cash flows in the same manner as the corresponding part of the present value of fulfilment cash flows for the underlying insurance contract.
- a cedant would not recognise a reinsurance asset until the underlying contract is recognised unless the amount paid under the reinsurance contract reflects aggregate losses of the portfolio of underlying contracts covered by the reinsurance contract. If the reinsurance coverage is based on aggregate losses, the cedant would recognise a reinsurance asset when the reinsurance contract coverage period begins. An onerous contract liability should be recognised if management becomes aware in the pre-contract period that the reinsurance contract has become onerous.
- in estimating the present value of the fulfilment cash flow for a reinsurance contract, the ceded portion of the risk adjustment, as applied in the IASB tentative model outlined above, represents the risk being removed from the use of reinsurance (IASB only decision). The FASB did not discuss this topic given their preference for a single composite margin, as outlined above.
- in recognition of gains and losses from reinsurance:
    - a cedant would not recognise a gain in profit or loss at inception of the reinsurance contract (contrary to the provisions in the ED); instead it would recognise a residual / composite margin that will be earned over the coverage of the reinsurance contract.
    - when the reinsurance contract covers pre-claims liabilities, a loss would not be taken to profit or loss immediately, but rather, amortised over the coverage period as a component of the reinsurance asset. However, if the reinsurance protection is for past events (i.e., retrospective reinsurance of post-claim liabilities) the loss would be recognised immediately.
- when considering non-performance by the reinsurer:
    - a cedant would apply the impairment model for financial instruments when determining the recoverability of the reinsurance asset.

  - the assessment of risk of non-performance by the reinsurer would consider all facts and circumstances, including collateral.
  - losses from disputes should be reflected in the measurement of the recoverable when there is an indication that on the basis of current information and events, a cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.

Presentation

Statement of financial position

The Boards tentatively decided that:

- an insurer should disaggregate the following components, either in the statement of financial position or in the notes to the financial statements:
  - expected future cash flows
  - risk adjustment (IASB only decision)
  - residual margin (IASB only decision)
  - the single margin, where relevant (FASB only decision)
  - the effect of discounting.

  If not presented in the statement of financial position, the amounts disclosed in the notes would be reconciled to the amounts included within the statement of financial position.
- for those contracts measured using the premium allocation approach, the liability for unexpired coverage should be presented separately from the liability for incurred claims in the statement of financial position.
- for those contracts measured using the building block approach, the unconditional right to any premiums or other consideration should be presented separately as a receivable from the insurance contract asset or liability and accounted for in accordance with existing guidance for receivables. The remaining insurance contract rights and obligations should be presented on a net basis in the statement of financial position.
- for those contracts measured using the premium allocation approach, all insurance contract rights and obligations should be presented on a gross basis in the statement of financial position.
- liabilities (or assets) for insurance contracts should be presented separately for those measured using the building block approach and those measured using the premium allocation approach.
- portfolios that are in an asset position should not be aggregated with portfolios that are in a liability position in the statement of financial position.

Statement of comprehensive income

The Boards tentatively decided that an insurer should present premiums, claims, benefits and the gross underwriting margin in the statement of comprehensive income. The Boards will consider at a future meeting whether these items should be presented separately in the statement of comprehensive income for contracts measured using the building block approach and the premium allocation approach.

Disclosure

The Boards tentatively decided to retain the disclosure requirements proposed in the IASB's ED, with changes as follows:

- to delete the requirement that an insurer shall not aggregate information relating to different reportable segments to avoid a conflict with the principle for the aggregation level of disclosures. Therefore, the level of aggregation may vary for different types of qualitative and quantitative disclosures. However, the standard would add to the examples listed in paragraph 84 of the ED by stating that one appropriate aggregation level might be reportable segments.
- to require the insurer to disclose separately the effect of each change in inputs and methods, together with an explanation of the reason for the change, including the types of contract affected.

- for contracts in which the cash flows do not depend on the performance of specified assets (i.e., non-participating contracts), to require disclosure of the yield curve (or range of yield curves) used to discount the probability weighted cash flows.
- to require the maturity analysis of net cash outflows resulting from recognised insurance liabilities proposed in paragraph 95(a) of the ED to be based on expected maturities and to remove the option to base maturity analysis on remaining contractual maturities. Furthermore, within the context of time bands, to require the insurer to disclose, at a minimum, the expected maturities on an annual basis for the first five years and in aggregate for maturities beyond five years. In place of this disclosure, the FASB would rely on its tentative decisions relating to risk disclosures for financial institutions. Those disclosures would apply to insurance entities.

In addition, the IASB tentatively decided to delete the proposed requirement in paragraph 90(d) of the ED to disclose a measurement uncertainty analysis and to eventually align that disclosure with the disclosure for fair value measurements in IFRS 13 *Fair Value Measurement*, as appropriate. The FASB tentatively decided to retain this disclosure.

Convergence

The Boards are split on the question of whether to restrict acquisition costs to those related to successful efforts, with the FASB in favour of a successful efforts approach whilst the IASB in favour of including costs arising from both successful and unsuccessful efforts.

The Boards are split on whether an insurer should deduct from the pre-claims obligation measurement the acquisition costs that would be included in the measurement of the insurance contract liability under the building block approach, with the IASB in favour of this approach. The FASB did not vote but appeared to prefer the guidance be aligned with the Revenue Recognition project.

The IASB tentatively decided that an insurer would account for an unbundled explicit account balance in accordance with the relevant requirements for financial instruments in IFRS, subject to future decisions on allocation. The FASB did not vote on this question. The Boards requested the staff to consider how the decisions would apply to typical types of insurance contracts with account balances.

The IASB tentatively decided to measure the par contracts' liability on a basis consistent with the underlying items. This would eliminate the undesired accounting mismatch; the remaining source of volatility in the financial statements would come from the economic mismatch as markets change. The FASB noted that they would prefer to value the liability using the building block approach, (i.e., project cash flows based on the contractual obligations of the insurer and use the fair value of the underlying items if that is what affects the benefits payable to the policyholder).

The IASB tentatively decided that the measurement of an insurance contract should contain an explicit risk adjustment that would be determined separately from the premium and re-measured during each reporting period, while the FASB tentatively decided that the measurement of an insurance contract should use a single margin approach that recognises profit as the insurer satisfies its performance obligation (as it is released from exposure to risk). The Boards are continuing to explore whether the two approaches could be made comparable through disclosures.

The IASB tentatively decided to require the maturity analysis of net cash outflows resulting from recognised insurance liabilities proposed in paragraph 95(a) of the ED to be based on expected maturities and to remove the option to base maturity analysis on remaining contractual maturities. Furthermore, within the context of time bands, to require the insurer to disclose, at a minimum, the expected maturities on an annual basis for the first five years and in aggregate for maturities beyond five years. In place of this disclosure, the FASB would rely on its tentative decisions relating to risk disclosures for financial institutions. Those disclosures would apply to insurance entities.

The IASB tentatively decided to delete the proposed requirement in paragraph 90(d) of the ED to disclose a measurement uncertainty analysis and to eventually align that disclosure with the disclosure for fair value measurements in IFRS 13, as appropriate. The FASB decided to retain this disclosure.

Thinking ahead

- Accounting for insurance contracts and participating contracts (either with or without insurance risk transfer) will be significantly affected by the tentative decisions reached by the IASB.
- Depending on transition requirements and linkage to accounting for financial instruments, possible accounting mismatches might remain and would need to be addressed. Potentially new asset-liability management strategies would need to be deployed.
- The requirement to estimate and explicitly report the three building blocks will have major system modifications and it will expose insurers' sources of profit to a level of transparency not experienced before.
- A risk adjustment model would require estimation of the underlying cash flows uncertainty based on the IFRS portfolio definition and one of the permitted valuation techniques. If a model based on the composite margin prevails, it would require the storage of extensive amount of data which would be released to income only over the combined coverage and claims handling periods.
- Closer relationships between finance and actuaries would be required to facilitate estimation of the insurance contract building blocks. This could have significant impact on the organisation and the level of skills insurers would need to sustain financial reporting processes under the new regime.
- The new presentation format of financial statements looking at insurance contract as a single net amount with separate components is a relatively new concept and it could impact multiple reporting processes within insurance organisations.
- Various stakeholders, such as policyholders, analysts, investors, regulators and providers of credit would need to be educated on the implications of the new standard for the entity.

Next steps

The IASB expects to re-expose its tentative decisions and the FASB expects to issue an initial exposure draft during the first half of 2012.

Appendix - Summary of Exposure Draft

Definition and scope

The boards tentatively decided to improve the definition of an insurance contract that is currently in IFRS 4 *Insurance Contracts* to clarify the role of timing in insurance risk and specifying that insurance risk would exist if there is at least one scenario in which the present value of net cash flows due under the insured event could exceed the present value of premiums.

The boards will slightly adjust the scope of the current IFRS 4, including:

- fixed-fee service contracts (new tentative scope exclusion);
- warranties issued directly by a manufacturer, dealer or retailer;
- residual value guarantees embedded in a lease provided by lessee or lessor, or provided by a manufacturer, dealer or retailer (this tentative scope exclusion has been expanded to include all types of lease and both lessees and lessors – the current IFRS 4 only has the lessees finance leases' guarantees as the types of leases scoped out);
- employers' assets and liabilities under employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans; and
- contingent consideration payable or receivable in a business combination.

Financial guarantee contracts will no longer be scoped out of IFRS 4 (currently they are accounted for under IAS 39 *Financial Instruments: Recognition and Measurement*).

Recognition

The insurer would recognise the rights and obligations arising from an insurance contract on the earlier of the insurer being obliged to provide coverage to the policyholder for insured events and the signing of the insurance contract.

In line with the current IFRS 4, the insurer would derecognise an insurance liability by applying the derecognition principle in IAS 39.

Measurement

The core of the proposed insurance model is a direct measurement of the insurance contract supplemented with an allocation over time of any accounting day one gain. The combination of rights and obligations arising from an insurance contract would be measured to portray the current entity-specific assessment of the future cash flows necessary to achieve the fulfillment of the contract. This measurement attribute is achieved using what is referred to as the 'building block approach' and presented on a net basis (rather than a separate asset and liability component). The building blocks include:

- the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract;
- the effect of time value of money;
- a margin separated into:
  - a risk adjustment that measures the effects of uncertainty about the amount and timing of future cash flows; and,
  - an amount that eliminates any accounting gain at inception of the contract which is subsequently released over the coverage period.

The measurement of an insurance contract under the current fulfillment value model represents an entity-based rather than market-based measure. Market data is required to be used only when directly observable prices match an input in one of the three building blocks (e.g., market interest rates to reflect the time value of money – the second building block).

All building blocks, except for the residual margin, would be re-measured at each reporting date.

The measurement of an insurance contract is based on expected contractual cash flows including the effects of policyholders' behaviours as to the exercise of renewal and cancellation options embedded in an existing insurance contract up to the point when the insurer is no longer required to provide coverage or has the right to reassess the risk of that policyholder, and as a result, can set a price that fully reflects that risk. This point in time is known as the contract boundary. All other options, forwards, guarantees that do not relate to an existing insurance contract coverage or that are exercised beyond the contract boundary are recognised and measured as stand-alone instruments or new insurance contracts.

The objective of the risk adjustment would be defined as '*the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected*'. The guidance would contain characteristics of techniques that can be used as well as description of three specific techniques permitted to be used – confidence level, conditional tail expectation and cost of capital. Other techniques would be permitted only if they meet these characteristics.

For pre-claim liabilities of short duration insurance contracts, an unearned premium measurement method would be required as a simplification of the building blocks approach when the level of claims expected during the coverage period is not expected to be significantly lower than the insurer initial estimate. Current rate should be used for the accretion of interest to an unallocated premium liability (subject to the materiality constraint).

Estimation of cash flows

The measurement of an insurance contract should include the probability weighted present value of all incremental cash-flows arising from the insurer's estimate of its fulfillment of the contract. This amount is based on the entity's own estimates of cash flows and probabilities with a requirement to use market prices only where directly observable in support for measuring future cash flows (e.g., the market prices of assets used to determine cash flows of asset-linked insurance benefits). An insurer should include, among the costs necessary to fulfil the contract, all costs directly associated with it (direct costs) and a systematic allocation of costs that relate to the contract or contract activities (indirect costs).

Insurance contracts should be treated in their entirety, including all the components, as monetary items. This would mean that insurance contracts with foreign currency cash flows would be subject to IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Pre-claims liabilities of short-duration contracts measured on an unearned premium approach would also be considered monetary items on the ground that this is merely a permitted shortcut method to achieve the same measurement required under the core cash flows estimate.

Discount rate

The discount rate should reflect the characteristics of the cash flows from the insurance contract (i.e., the risk-free rate plus an adjustment for illiquidity), rather than the characteristics of the assets held to back the contracts' liabilities, unless the contracts share those characteristics.

Margin

The ED includes two approaches to margins: (1) a single composite margin approach that is preferred by the FASB and (2) a separate risk adjustment and a residual margin approached favoured by the IASB.

The risk adjustment is determined with reference to a portfolio of contracts (unit of account) comprising contracts that share the same risk characteristics and are managed together as a single portfolio.

The IASB decided to accrete interest on the residual margin, whereas the FASB decided not to accrete interest on the composite margin. The rate of interest applicable to residual margin would be either locked (as proposed in the ED) or current (presented as an alternative in the ED).

The ED specifies three techniques available to determine the risk adjustment (and no other technique could be used) (1) Confidence level, (2) Conditional tail expectation (CTE) and (3) Cost of capital.

Unbundling

For recognition and measurement, 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. An insurer shall unbundle the following components of a contract that are not closely related to the insurance coverage specified in that contract:

(a) policyholder account balances that bear a crediting rate determined by the investment performance of the underlying investments (supplemented with additional guidance);
(b) embedded derivatives that are separated under existing bifurcation guidance; 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.

Acquisition costs

All acquisition costs should be expensed when incurred. Direct and incremental acquisition costs at the contract level should be included in the contract cash flows to determine the residual margin at the inception of the contract.

Participating features

Payments arising from a participating feature would be included in the measurement of insurance contracts in the same way as any other contractual cash flows (i.e., on an expected present value basis).

The ED proposes that investment contracts with a discretionary participation feature issued from a participating fund that is also used to back participating insurance contracts will be within the scope of the proposed IFRS. The ED discusses the treatment of such contracts as financial instruments subject to the IFRS for financial instruments accounting, with a specific question in the Invitation to Comment as to what respondents would prefer.

Reinsurance

The recognition and measurement criteria for reinsurance assets would be based on the building blocks approach, except that measurement of reinsurance assets should include an adjustment for reinsurer's expected credit losses.

A cedant shall not recognise any negative residual or composite margins when measuring a reinsurance asset, but instead, it recognises a gain in profit or loss at inception of the reinsurance contract.

A cedant should recognise any ceding commissions arising from reinsurance contracts as a reduction of the premiums paid to the reinsurer.

Presentation

The presentation of insurance contracts in the statement of comprehensive income will be driven by the measurement model. The Boards proposed a '*summarised margin*' presentation model that treats all premiums as deposits and all claims expense, claims handling expense and other contract-related expense as repayments of deposits. The release of both the residual margin and the opening risk adjustment feed into an insurance margin income sub-total that refers to the release of the two margins through income over the period.

Other required line items are:

- the changes in estimates incorporating the income or expense arising from the reassessment at the end of the period of both expected future cash flows and the associated risk adjustment;
- the income or expense from the experience variances arising from the comparison of actual cash flows against those expected to occur in the period; and

- the unwinding of discounting presented against income from investments to produce an investment margin sub-total

Other decisions

A key consequence of the inclusion of future cash flows within the contract boundary is that the measurement is not subject to a "deposit floor". In addition it would not be updated for changes in the risk of non-performance by the insurer.

The ED also includes guidance on insurance contracts assumed in portfolio transfers or acquired in business combinations.

Transition

Portfolio of insurance contracts existing at the beginning of the earliest period presented should be measured at the expected present value of cash flows arising from the portfolio of contracts plus a risk adjustment. Any difference with the previous measurement should be recorded in retained earnings. Any balances of deferred acquisition costs and any intangible assets arising from insurance contracts assumed in previously recognised business combinations shall be derecognised and adjusted against retained earnings.

Re-designation of fair value options for financial assets held to back insurance contracts at the date of initial application is permitted for entities issuing insurance contracts.