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Insurance Accounting Newsletter
Focus on the estimate of insurance cash flows

The Boards agreed that the guidance on cash flows estimates should receive a prominent position in the Exposure Draft.

The joint work of the Insurance Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) continued in March with a relatively limited agenda.

The IASB and FASB (together, the Boards) met respectively on 19 and 26 March 2009 to discuss the draft guidance on the estimate of insurance cash flows that could be included in the future accounting standard. The estimate of cash flows is Block 1 of the future measurement model; Block 2 will be the selection of the discount rate and Block 3 the measurement of the margin.

The Boards' Staff prepared an analysis of the possible guidance under both the exit or fulfilment notions owing to the Boards' pending final choice on the measurement model. The Boards agreed with the level of detail of the proposed guidance and indicated to their Staff that it should receive a prominent position in the Exposure Draft due to be published in December 2009.

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Overview of the IASB March meeting

The Staff proposed text for a new accounting standard that uses the Current Exit Price (CEP) measurement model originally presented in the 2007 IASB Discussion Paper "Preliminary Views on Insurance Contracts" (the DP). In addition the Staff prepared an analysis of this text highlighting areas where an accounting standard developed from a Current Fulfilment Value notion (CFV) would require different guidance.

As explained in Deloitte's first Insurance Accounting Newsletter, CEP and CFV would account for the insurance contract from a different view in relation to who is ultimately assumed to hold the contract liability. With the exit notion, a generic market participant is assumed to hypothetically take over the liability at the balance sheet date and the accounting is about estimating what current value such market participant would demand to take over the contract. Whereas in the fulfilment notion, it is the specific insurer who sold the policy to assume it will hold the contract until its obligations are fulfilled and accordingly it determines the unbiased current value of completing all of the remaining unfulfilled obligations.

The draft guidance discussed at the Boards' March meetings was organised in seven different areas. As explained above, for each of these the Staff presented a comparative analysis under the two possible models. The table below summarises the draft guidance along with the analysis of the differences between CEP and CFV.

Draft guidance on the estimation of insurance cash flows – proposed categories	CEP compared to CFV		
	Identical	Similar	Different
Uncertainty and expected present value approach	■		
Consistency with current observable market prices	■		
Required sources of estimates to be considered		■	
Requirement to use current estimates	■		
Expected loss model for future events	■		
Cash flows included and excluded from block 1		■	
Use of entity-specific cash flows in absence of observable prices			■

The debate highlighted that there is a substantial degree of guidance that would not change as a result of the final choice of measurement model.

- Both CEP and CFV will require the adoption of a prospective estimation that is unbiased and takes into account the current probability of each scenario under the policy rather than selecting the scenario with the highest probability of occurring. The draft guidance clarified that these probabilities are specific to the risk underwritten thus the market consistent and the entity-specific views are the same. In addition, because both models are prospective, they would need to take into account future losses under existing contracts, i.e. both models will use an expected loss rather than an incurred loss approach.

- The use of observable market prices to produce the current estimate is applicable to both models. As discussed at their February meeting, observed interest market rates would be the most important input albeit they would be used for the selection of Block 2 – the discount rate – rather than for the estimation of Block 1. An example of relevant observed market prices for Block 1 would be the unit price measure for unit-linked insurance contracts. These prices would be used directly to estimate the liability under both the CEP and CFV approach.

- The application of a current measurement prevents the "lock in" of any assumptions. However the draft guidance explained that the most recent experience does not necessarily equate to a current estimate and it would need to be analysed together with all other available evidence.

The draft guidance was not the same for the two models in other areas. These differences exist for two main reasons:

- The CEP approach would require an insurer to include among its estimation inputs all the available market prices arising from portfolio transfers, the reinsurance and the alternative risk transfer markets. The efforts to identify and use these prices would be required to establish the market participant's view of the future cash flows from the contracts. Under the CFV instead such requirement would not apply in the same stringent manner and the insurer would look at these pieces of information as it applies the principle of conducting an unbiased estimation using all available evidence.

- Similarly the CEP would prohibit the use of entity-specific data when there is evidence that market participants would not come to the same view. An example of this difference from the discussion at the last meetings was around the various types of expenses that insurers incur to administer their policies, handle their claims and settle some of their claims in-kind.

The impact of entity-specific efficiency on the settlement of claims in-kind (e.g. under a motor breakdown insurance contract) raised a suggestion of an alternative approach to the estimation of Block 1.

One of the Board members at the IASB suggested exploring an approach where Block 1 only represents the estimate of future actual cash flows. The estimate of performance obligations that would be settled in other form would be captured by the margin.

In this alternative approach the margin would include an estimate of future expenses and benefits in-kind related to the contract, the liability for the uncertainty of the estimates (a risk margin) and any other future profit that the insurer expects to make from the contract. The third of these components would be calibrated to the price negotiated with the customer in the CFV model whilst it would be measured with reference to the hypothetical market participant in the CEP approach.

This debate prompted the comment from some of the Boards' members that the issue of subsequent measurement is important for their future debates. In particular, the new accounting standard will need clear principles on the interaction among the three building blocks. In that context they also raised the need to continue comparing the developments of the insurance accounting standard with the proposed model for revenue recognition.

The Staff agreed to incorporate all these comments in the papers that will be discussed at the Boards next meetings.

Conclusion and next steps

The Boards plan to have an intense session at their next meetings as their decision-making process seems to gather pace.

The agenda is expected to cover the issue of subsequent measurement and the treatment of acquisition expenses. The comments from the March meeting should help Staff with their preparatory work ahead of what seems an important stage in the development of the new accounting standard.

In addition to these items the Boards plan to hold an educational session on contract approach (unit of recognition) during which they will look at renewal and cancellation rights and at the complex issue of participating business.

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