

## Insurance Accounting Newsletter

### The start of a new accounting era



### Background

On Friday 30 July 2010, the International Accounting Standards Board (IASB) reached an important milestone in its project to improve accounting for insurance contracts by publishing an Exposure Draft (ED) that fundamentally revises International Financial Reporting Standard 4, *Insurance Contracts*. The ED is the latest step in developing an entirely new insurance accounting standard that will complete the Phase II of the IASB's Insurance Contract project (IFRS 4 Phase II). The comment period closes on 30 November 2010 and the final standard is due to be released in June 2011.

Although the implementation date has not yet been decided upon, it is proposed to be aligned with the mandatory application of the new accounting standard for investments (IFRS 9 *Financial Instruments*), currently due on 1 January 2013. Based on comments it receives, the IASB will consider aligning both standards' implementation dates.

The IASB objectives with this ED are to eliminate inconsistencies and weaknesses in existing practices allowed under the current text of IFRS 4 *Insurance Contracts* (published in 2004), the outcome of the first phase of the IASB's Insurance Contracts project (IFRS 4 Phase I).

The current IFRS 4 is an interim standard that allows insurers to continue using, for their insurance contracts, existing non-IFRS accounting practices that have developed in a piecemeal fashion over many years. With this ED, the IASB aims to deliver a comprehensive, investor focused and consistent IFRS accounting framework informed by the principles of current measurement and transparency.

The publication of an IFRS for insurance contract accounting has been under development since 1997 and the ED of IFRS 4 Phase II finally proposes a standard for all insurance and reinsurance contracts, both life and non-life. Since the Financial Accounting Standards Board ("FASB") joined the project in October 2008, the development of IFRS 4 Phase II has rapidly evolved into a key convergence project. The FASB will also be publishing the IASB's ED in the coming weeks as a Discussion Paper that will seek the views of US reporting entities and users on the convergence of US Generally Accepted Accounting Principles (US GAAP), towards the new IFRS model.

The ED requires insurance liabilities to be measured using a transparent building blocks accounting model based on discounted probability-weighted best estimate cash flows. The proposal for insurance liabilities to be recorded on a current value basis using market consistent inputs to inform the best estimate of future cash flows significantly changes the current accounting for insurance and, as a consequence, the development of IFRS 4 Phase II has been controversial. The accounting for the volatility inherent in the best estimate remains a subject of controversy and, as the IASB and FASB failed to reach an agreement, two different methods are proposed in the ED. In addition, the requirement to have separate accounting bases for assets and liabilities when measuring the value of insurance contracts will be particularly contentious in some countries.

We encourage you to read carefully the full text of the ED, assess the impact its requirements will have on your business and respond to the ED's questions. Deloitte partners and staff would be happy to assist you with your assessment and response. Please do not hesitate to approach your usual Deloitte contacts or one of the partners listed at the back of this newsletter.

## Measurement model

The ED proposes that all insurance contracts are accounted for with a measurement model that uses a transparent "building blocks" 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 cash flows from the insurance contract".

This first building block comprises the projected future cash flows expected to arise as the insurer fulfils the obligation under the insurance contract being measured. The contract boundary, an important and innovative feature of this model, is defined as the point at which the insurer can unilaterally terminate or re-underwrite a policyholder's contract. All cash flows that fall within the period set by the contract boundary should be included in this building block.

The insurance contract should be initially recognised at the earlier of the signing date or the effective date of the contract and derecognised when it no longer represents a liability of the insurer.

### Observations

The initial recognition principle is aligned with other IFRSs as it uses the date of the contractual obligation to start the accounting process of an insurance contract. In addition, by aligning with the general IFRS concept of recognising a liability when an entity has an unavoidable obligation, it requires 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. This happens when, for example, an insurer has made a legally binding irrevocable unilateral commitment to stand ready to pay claims.

Accounting for insurance contracts on this basis will require changes in all those cases where the insurer has used the "risk inception date" to recognise insurance contracts. This approach is particularly common among general insurers that underwrite property and casualty risks.

The process to estimate these 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 (on an expected value basis i.e. probability weighted) that are integral to the fulfilment of the insurance contract including premiums, expenses, benefits and claims payments, as well as the incremental acquisition costs, and the benefits that an insurer expects to pay to policyholders of participating insurance contracts (policyholder dividends).

Observable market data must be considered in developing the estimates whenever it feeds directly in the variables used to determine the expected present value. For example, market interest rates must be considered to determine the discount rate underpinning the second building block.

Due to this "entity specific" approach focused on the entity's fulfilment obligations, this method is referred to as the "current fulfilment value" approach.

### Observations

Probability-weighted estimates may imply a stochastic set of scenarios, with each given equal weight, but may also imply a set of deterministic scenarios, each given a specific probability based on an unbiased view of the probability of that scenario occurring. The idea is not to produce a single most likely scenario but to consider a range of outcomes and to use all available information. This requirement is generally not used in current accounting models and will require model and system adjustments to produce timely financial information.

A very important characteristic of the first building block of the measurement model is that it requires the inclusion, among the contractual cash flows, of acquisition costs that are directly attributable and incremental to the activities of selling, underwriting, and initiating each individual insurance contract.

All other acquisition costs for the sale and underwriting of insurance contracts, as well as the costs for aborted sales, must be expensed as incurred. This is in line with all other IFRS.

#### Observations

The requirement to consider directly attributable and incremental acquisition costs in the first building block means that issuing an insurance contract does not necessarily 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).

This narrow definition of acquisition costs and the role that directly attributable and incremental costs will play in the new model may require adjustments in some 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 discount rates that are based on the characteristics of the insurance liabilities – i.e. their currency, duration and liquidity. The discount rate should not reflect the characteristics of the assets backing the liabilities, unless the amount, timing or uncertainty of the contracts' cash flows depends on the performance of specific assets (e.g. participating contracts).

The discount rate should be determined using a risk free rate, adjusted with an illiquidity premium calibrated on the illiquidity of the contractual cash flows. For example, a payout annuity displays highly illiquid cash flows because the policyholder cannot withdraw cash from the contract or redeem the contract at will.

There is not currently a widely accepted technique for determining illiquidity premiums. The ED includes disclosure requirements relating to the process used to select material assumptions, including the method for selecting discount rates and the associated illiquidity premiums when applicable. The approach to the selection of discount rates is similar to the basis used in the IFRS for non-insurance provisions (IAS 37) and to the approach used under the fair value measurement of financial instruments (IAS 39).

#### Observations

A number of existing accounting models use asset-based approaches to determine the discount rate for insurance liabilities. For example, certain national accounting standards include requirements to link the discount rate of insurance liabilities to the assets which the insurer has purchased to back them, irrespective of whether or not the insurance contract cash flows are affected by the value of these assets.

The proposed guidance requires an asset based discount rate only where such a link exists, such as for participating contracts. The guidance also suggests an insurer may use replicating portfolios to determine an asset based discount rate.

For non-participating contracts the ED effectively delinks the discounting of insurance liabilities from the assets supporting them. This may result in an increased insurance liability on transition (and a related decrease in equity) and increased earnings volatility for certain components of the return on assets. This comes from the fact that the movement in liabilities and assets, that have been assumed to be the same in certain jurisdictions, may be significantly different – for example to the extent that any part of the assets' interest rate is not reflected in the liability discount rate.

Whilst an insurer can theoretically match perfectly the currency, duration and illiquidity of assets and liabilities, the one component that cannot be matched is the credit spread in the asset valuation; credit risk is not reflected in the liabilities' cash flows unless the insurer has a contractual obligation to do so.

The extent to which this requirement will impact insurers will depend on the past practice in use at each company and whether the insurance contracts of that company have a particularly long duration. The amount of 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.

Losses may also arise on recognition of an insurance contract when insurers decide to price a contract assuming an expected return on assets in excess of the discount rate used for measuring the liability.

Insurers will need to develop their approach to determining the risk free rate and methodologies to determine the illiquidity premium; systems and processes will need to be re-configured to discount insurance contracts based on liability characteristics. In addition, as practice evolves, the principles based approach to calculating the illiquidity premium could potentially lead to a period of reduced comparability in financial reporting.

### Building Block 3 – a margin to reflect uncertainty and future profits

As a consequence of the disagreement between the IASB and FASB on how to account for the volatility of insurance contract cash flows, the ED asks for feedback on two different proposals relating to the margin that represents the third building block.

The model proposed in the ED is one that requires the uncertainty of the cash flows estimate to be explicitly measured in a risk adjustment liability, calculated using one of three permitted techniques set out in the ED.

Any accounting profit, that might otherwise be recognised if the insurance contract were measured as the sum of the expected value (i.e. the first and second building blocks) and the risk adjustment, is captured by a residual margin liability such that there can be no reported day 1 profit.

The alternative model, as preferred by the FASB, is to avoid the explicit measurement of the estimation uncertainty and capture it together with any future profit in a “composite margin”, which would be subsequently released to profit based on the unwind of the insurer’s risk exposure and related uncertainty.

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

	Risk adjustment plus residual margin	Composite margin
<b>Margin components</b>	Two components: <ul style="list-style-type: none"> <li>The risk adjustment liability is explicitly reported to represent the maximum amount that an insurer would rationally pay to be relieved of the risk that the cash flows may exceed those estimated.</li> <li>Residual margin to eliminate any gain at inception, if applicable</li> </ul>	Single component: <p>Composite margin that eliminates any gain at inception and that captures the amount that the insurer charged the policyholder to accept the uncertainty of the insurance risk transferred under the contract.</p>
<b>Day one loss and calibration to eliminate accounting gains at inception</b>	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 liability.  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 <b>does not</b> include a risk adjustment liability.  Any accounting loss is recognised immediately.
<b>Interest accretion</b>	The residual margin will accrete interest at the same rate used to discount the expected value, as determined at initial recognition.  The explicit risk adjustment will not accrete interest.	The composite margin will not accrete interest.
<b>Available techniques</b>	Three permitted techniques can be used to determine the risk adjustment: <ul style="list-style-type: none"> <li>Confidence level.</li> <li>Conditional tail expectation.</li> <li>Cost of capital.</li> </ul>	Not applicable.
<b>Level of aggregation</b>	<ul style="list-style-type: none"> <li>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 portfolio.”</li> <li>The residual margin should be determined at a cohort level which combines contracts within a portfolio by similar date of inception of the contract and by similar coverage period.</li> </ul>	The composite margin should be determined at a cohort level.
<b>Subsequent treatment</b>	<ul style="list-style-type: none"> <li>The risk adjustment should be re-measured at each reporting date.</li> <li>The residual margin should not be re-measured in subsequent reporting periods other than for its systematic release to income.</li> <li>The residual margin will be released to income in a systematic way over the period of the insurance coverage.</li> </ul>	<ul style="list-style-type: none"> <li>The composite margin should not be adjusted in subsequent reporting periods.</li> <li>The composite margin will be released over the combined coverage plus claims handling period based on the following formula:  <b>(Premium allocated to current period + current period claims and benefits)/(Total contract premium + Total claims and benefits.)</b></li> </ul>

### 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 an evolving and complex area of practice.

Choosing the appropriate valuation technique from the three permitted, defining the correct level of aggregation and calibrating the technique to the portfolios could be a challenge for companies to implement and maintain. Changes in profit recognition patterns could arise from these changes.

Access to an increasingly granular data could offer a competitive advantage to companies in defining the optimal portfolio for aggregation which would maximise diversification benefits, thus reducing both liabilities and volatility of earnings. Calculating probability distributions or stochastic models for insurance liabilities at the portfolio level and developing adequate support for assumptions will require robust and auditable processes that can bear the scrutiny of market disclosure.

If a composite margin model is eventually selected, the calibration and subsequent release of margins will require companies to link current information back to premium and other values, either set at contract inception or updated at each reporting period. This information may provide insight into the validity of the insurer's original pricing assumptions.

## Measurement model – Simplified approach for short term contracts

The ED requires the use of a shortcut method for all those contracts that have a coverage period of 12 months or less and that do not contain any embedded derivatives. For such contracts, this simplified method requires different measurement approaches for the pre-claims liability (recorded before claims are estimated to be incurred) versus the post-claims liability (recorded after claims are estimated to have been incurred).

The pre-claim liability is calculated initially as 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), adjusted to reflect circumstances where the pattern of the timing of claims may not directly correlate with the passage of time (e.g. weather related claims).

The post-claim liability will always have to be measured using the three building blocks and insurers that are required to use the simplified approach will establish the post-claim liability as the pre-claim liability is released.

The release of the initial pre-claim liability through income as described above aligns the profit pattern under this method to the core model based on the building blocks plus residual margin. In both cases the residual margin 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 ED clarifies that all insurance contract liabilities (including the pre-claim liability under this simplified approach for short term contracts) shall be treated as monetary items under IAS 21.

### Observations

The simplified approach applies the existing practice known as the unearned premium method on a net of incremental acquisition cost basis. This approach is a requirement under the ED and it would result in a strict application to all contracts that have the stated features of short term coverage and simplicity of terms (no embedded derivatives).

An analysis of existing practices where the unearned premium is utilised will be required to ensure that the practice is continued only where required.

The treatment of the pre-claim liability as a monetary item eliminates an existing mis-match under IFRS.

The ED requires insurers to release revenue from the pre-claims liability in a manner that reflects the seasonality of expected claims. This approach to revenue recognition will be familiar to many insurers (particularly property catastrophe reinsurers), but may be new to others.

The ED specifies that this simplified approach is developed as a shortcut of the main model based on the building block approach and it does not represent an alternative basis to the accounting approach used for insurance contracts.

## Contract boundary

A difficult conceptual issue the ED has resolved is the reconciliation with the IASB Framework's definitions of an asset and a liability. For a large number of long term insurance contracts analysing the contract's rights and obligations separately could lead to the conclusion that the obligation to pay claims is unconditional and must be recognised in full whilst the rights to receive future premiums from the policyholder can be recognised as an asset, only to the extent that the right to receive premiums is enforceable. Such an analysis would produce a large liability, unrepresentative of the underlying economics of a long term insurance contract.

The ED has instead adopted an approach focused on the contract as a bundle of rights and obligations. The proposed approach assesses the merit of accounting for the options a policyholder has to cancel or renew the contract. The conclusion is that these options are integral to the contract and the model must include their impact in the measurement of the first building block. Their measurement is carried out within a time limit that the ED defines as the boundary of the insurance contract. This is a point in time in the future when the insurer is either able to cancel or decline the offer of insurance coverage to the policyholder or, 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 logic of a contract basis, rather than one focused on individual rights and obligations, captures the economic substance of the insurance contract. The IASB and the FASB have decided to apply the same logic to the revenue accounting standard in the allocation of customer consideration.

### Observations

The concept of contract boundary is, for many, an innovative approach to accounting for contracts with contingent cash flows; it will require a careful assessment of its treatment in all actuarial models to ensure that the full benefit of future premiums is only counted to the extent that they fall within the contract boundary.

The wider application of this concept to the overall IFRS revenue model would make this assessment relevant also to other non-insurance services sold (such as asset management services).

Another important implication of the contract-based approach is that the ED requires a single accounting balance to be presented displaying the bundle of rights and obligations at the reporting date. This approach ties well with estimating future net cash flows, an idea at the core of the building block approach. The outcome of this principle is that it is possible for long term regular premium contracts to be displayed as insurance contract assets in the first few reporting periods when the net expected value of premiums exceeds that of future benefits.

## Participating features

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

Insurers frequently offer to their policyholders the option to receive significant additional benefits over and above guaranteed benefits. These supplemental benefits are determined by the insurer on a discretionary basis. However, this discretion is always constrained by a reference amount which can be obtained from one of following:

- (i) the performance of a specified pool of insurance contracts or a specified type of insurance contract;
- (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, a discrete fund or other entity that issues the contract.

This regime of “constrained discretion” had caused substantial difficulties at the time IFRS 4 Phase I was released, which the IASB then resolved by allowing insurers to be free to decide whether to treat the participating feature as a liability, an equity component or to split it between the two categories.

The ED closes this issue by proposing 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, included in the estimation of the future cash flows the insurer will pay to its policyholders. This approach requires insurers to estimate the future performance of the underlying variable as well as 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 in both insurance contracts and financial instruments that do not transfer insurance risk. To ensure consistency of treatment, all financial instruments with participating features that use a common reference to insurance contracts will be scoped into the ED for insurance contracts, rather than IAS 39. This scope decision is in line with the approach used under IFRS 4 Phase I.

For its approach under US GAAP, the FASB decided to apply the general financial instruments accounting model to these financial instruments which may create differences with the IFRS 4 Phase II model due to the restriction to include future policyholder dividends that exist in the financial instrument accounting model.

Other important features for participating insurance and investment contracts are:

- 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. The boundary is set at the time when the holder is no longer able to receive the supplemental benefits set out at the inception of the contract; and
- The requirement to earn the residual margin of participating financial instruments on a basis reflecting the value of the asset managed within the participating fund.

FASB’s decision to avoid a scope exception for participating financial instruments leaves open the possibility of an amortised cost approach for these liabilities. The absence of a contract boundary concept within the financial instruments standard would create a potentially significant difference between the two bases particularly when the funding conditions in the contract allow investors to make regular payments into the contract in order to increase their right to receive future participating benefits.

### Observations

The solution to the accounting of participating contracts is one that would be applied to an area where the IFRS 4 Phase I practices were allowed to be significantly different. The full range of classification options as a liability, equity or a split between the two can be found across IFRS reporting insurers under the current IFRS.

As well as bringing consistency of treatment, the ED approach will also bring one of the biggest implementation challenges at transition date. The new approach will demand the analysis of the surplus arising from participating funds held on the balance sheet 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 former will be part of the insurance contract liability, whilst allocating it to the latter will flow to the insurer’s equity.

Considering the large 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 of the new requirements at the earliest opportunity to understand intimately the outcomes of transition and subsequent accounting as well as to manage a potential “windfall” to shareholders if the IFRS 4 Phase I election was to classify the whole of the participating surplus as a liability.

## Definition and scope

The development of IFRS 4 Phase I back in 2004 was focused on the introduction of a workable definition of insurance contracts, such that it was clear to investors what types of transactions would have benefited from the grandfathering of past national accounting practices under IFRS.

Since then, the definition has been working effectively among IFRS reporting entities and the ED introduces only limited refinements to that definition to clarify the pre-existing principles and align the IFRS 4 Phase I definition to existing practices.

The first refinement introduces the requirement to use present values to carry out the test on insurance risk significance. This practice was already applied for insurance contracts where the insured event was the survival of the policyholder as the comparison of the benefits owed on survival with other benefits payable at other times (e.g. the policy surrender value), could only be done using the present value of the benefits payable at the survival date.

The second refinement is to add more guidance to the requirement that the scenarios considered for the insurance risk significance test have commercial substance. The new guidance explains that, 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 refinements have been added to facilitate the agreement with the FASB that US GAAP will move to adopt the IFRS contract definition.

The ED also contains a couple of important scope changes:

1. **Financial guarantee contracts** – these contracts have always met the definition of insurance contracts. However, IFRS 4 Phase I includes a scope exemption that enables financial guarantee contracts to be accounted for under IAS 39. The ED removes this exception and financial guarantee contracts issued will be accounted for as insurance contracts. The ED does not cover insurance policyholder accounting (with the exception of reinsurance purchased by insurers) and therefore the holders of these guarantees would need to continue to account for them as before; and

2. **Fixed fee service contracts** (such as maintenance contracts or roadside assistance) – These contracts were in the scope of IFRS 4 Phase I. The IASB and FASB decided that the new revenue standard would be able to deal with the insurance risk included within these contracts, that contain primarily a service obligation, and thus decided to require them to be scoped out of the IFRS 4 Phase II standard.

## Unbundling

When IFRS 4 Phase I was developed, there was significant debate surrounding unbundling. The compromise was a fairly limited guidance; it required unbundling only if the insurer could measure the deposit component separately, and if its accounting policies did not otherwise require it to recognise all obligations and rights from the deposit component. In practice, these conditions were rarely met and cases of mandatory unbundling under IFRS 4 Phase I were few and far between.

The IASB and FASB agreed that the ED will carry a more extensive unbundling regime. The initial guiding principle on unbundling, based on lack of significant interdependence among bundled components, has been replaced in the final text of the ED by an approach that requires unbundling of a component every time it is not “closely related” to the insurance coverage.

The statement of close relationship comes with three specific examples where unbundling is mandatory. These relate to three specific components that could be bundled in an insurance contract:

- (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 the unbundling of the deposit components under (a) above has to be done for the “naked” deposit only. All fees and charges associated with it would continue to be treated as belonging to the insurance component or another component of the bundled contract (which may or not be required for unbundling).



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, due to the fact that surrender options usually determine the cancellation of the whole contract, they are interdependent with all the other components and thus closely related to the insurance coverage.

#### Observations

There are significant implications to the life insurance industry and cash flows will need to be considered on a product by product basis. Because the unbundling principle still operates within the definition of an insurance contract, the ultimate determination of the features in each component will need to be made on an individual contract basis. Implications to the life insurance industry range from, separately accounting for account values in “savings” products and universal life type products, to the bifurcation of embedded derivative guarantee products.

## Presentation

Besides developing the measurement approach for insurance contracts, the ED states 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** – This line would include the earnings from the release of the residual margin over the coverage period and the earnings from the insurer being released from risk in line with the reduction in the risk adjustment liability. The ED requires the inclusion, within this line, of the changes in the risk adjustment liability associated with the re-measurement of the expected value at the reporting date. Under the composite margin model this line will include its release to income.

- **Gains and losses on initial recognition** – This line would capture 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** – This line would include the differences between expected and actual cash flows, the re-measurement of future cash flows and changes in the discount rates used to account for time value of money.
- **Interest expense on the insurance liabilities** – This line would disclose the unwind of the discounting, preferably together with the results from investments backing insurance liabilities.

Specific additional lines will be added when the simplified method is used to present the earning from the release of the unearned premium liability separately from the claims liability expense.

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 underpin the profit recognition.

#### Observations

The summarised margin approach is relatively new to IFRS and several existing accounting practices where a “gross flows” presentation is used displaying as revenues the contract’s inflows and the outflows as expenses.

Although the supplementary reporting known as “embedded value” adopts a similar approach to displaying a life insurer’s performance, this approach is uncommon among general insurers. The focus on cash flows and the building blocks is a response to the IASB’s enquiries with users of financial statements who indicated their need to monitor that particular dimension of the insurance business to make their investment decisions.

Changes to general ledgers and underlying accounting systems will be needed to accommodate the new requirements. Implementation of the necessary processes to capture the required data could be challenging if left to a later phase of an insurer’s implementation plans.

For each of the lines required in the ED, the additional required presentation items noted above under each caption could be included as separate lines or disclosed in the footnotes.

## Disclosure

The revised 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 forth 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 contracts .

The ED also states the maximum aggregation for disclosure purposes is the operating segment as defined under IFRS 8. It also requires that the disclosures allow the figures to be reconciled to the items displayed on the face of the financial statements.

Unlike the requirements of IFRS 4 Phase I, the ED is fairly prescriptive on the format these disclosures should have. For example the ED explains in greater detail than the current IFRS the individual line items that will have to be included in the reconciliations from opening to closing balance explaining the movement of insurance contracts carrying amounts. These tables will have to be structured to evidence to the user the movements in each of the building blocks.

The ED expands and tightens the requirements on the assumption setting processes that an insurer will use under the measurement model. In particular the ED introduces a reconciliation of the risk adjustment assumptions under the cost of capital and conditional tail expectation methods, to those that would have been equivalent to using the confidence interval method.

The ED maintains the requirement to produce loss development tables of post-claim liabilities with an initial depth of five years to gradually increase to a maximum of ten years. The gradual increase to a ten-year loss development table cannot be invoked by existing IFRS reporting entities which have been complying with this disclosure since 2005 and will have published loss development tables starting from the year 2000.

### Observations

The ED does not significantly alter the disclosure requirements from IFRS 4 Phase I. However, it requires a more extensive level of disclosure than historically has been required under local country GAAP. Additionally some of the disclosures previously required by IFRS 7 have been incorporated into the ED.

This added level of disclosure will require insurers to reassess the way that they capture and manage data.

Insurers will also need to assess current systems capabilities and the appropriateness of internal controls over financial reporting.

## Unit-linked contracts

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

These exceptions to the general IFRS principles in IAS 32 and IAS 16 respectively 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 could not be recognised as assets in normal circumstances (they would be accounted for as a deduction from equity). However if they are placed in a unit-linked fund the issuer has 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 GAAP. This requirement puts all of the assets backing unit-linked contracts within a single balance sheet line. 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 and financial instruments that have a unit-linking feature.

The only area of accounting mismatch known from the implementation of the IFRS 4 Phase I that the ED does not resolve is that arising from a unit-linked fund investing in a subsidiary of the issuer. In that 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 within the scope of the ED.

The overall approach is the same as described for insurance contracts, i.e. the use of a 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 ceded risk adjustment is also a function of the reinsured risks and, the riskier the portion of cash flows that the cedant has reinsured, the bigger the carrying amount of the reinsurance assets;
2. if a cedant pays for the reinsurance contract an amount that is smaller than the resulting asset it has recognised in its financial statements, it will recognise that positive difference immediately as a gain through income. A negative amount would represent a ceded residual margin (or ceded pre-claim liability) and is amortised through income over the period of reinsurance coverage; and
3. in addition to the measurement required under the building blocks model, a cedant must include an allowance for the expected losses that will arise from the reinsurer's non-performance.

### Observation

The requirement to apply an expected loss model to measure any impairment of reinsurance assets is a change from IFRS 4 Phase I, and differs notably from the current approach under many national GAAPs. It matches the current proposed change to the impairment model for financial assets.

## Transition and effective date

The ED is not definitive on the effective date of the new IFRS. The tentative date is 1 January 2013; however the decision will only be taken when the IASB has completed an assessment of the combined impact of the ED and the requirements of IFRS 9. The IASB has stated that the implementation of these two standards will move in parallel.

On adoption of the new accounting regime, insurers will have to restate their insurance contracts liabilities through a series of adjustments that include:

- Writing off to opening retained earnings of all insurance intangible assets such as non-incremental deferred acquisition costs or intangible assets recognised on acquisition of insurance businesses and portfolios.
- Restating 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 taken to opening retained earnings. No residual margin liability would be recognised on transition.

### Observations

The transition to the new regime would transfer to opening retained earnings any surplus that is not captured by the building blocks.

The estimate of a proper risk adjustment is likely to be the most crucial activity on transition as it would determine the primary sources of future accounting profits from the contracts in force at transition date. The FASB has decided that it would deem the risk adjustment liability to represent the opening composite margin under the alternative model.

As noted above, the presence of large "inherited estates" would further complicate the restatement of participating insurance and investment contracts.

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 and loss category if this reclassification reduces accounting mismatch on adoption of the new IFRS. If this option is taken, it would be a change in accounting policy under the IAS 8 *Changes in Accounting Policies* and would need to be applied retrospectively. No reclassification to other measurement categories would be permitted.

The transitional provisions are the same for existing IFRS reporting entities and for first time adopters.

## Conclusion

It is no exaggeration to suggest that this proposed accounting standard for insurance contracts will fundamentally change the way in which insurance companies measure, report and evaluate the performance of their insurance contract obligations. Every aspect of insurance accounting, from the definition of insurance, to measuring the liability, to presenting and disclosing the measurement in the financial statements, has been thoroughly reconsidered.

Almost every insurance company will experience a significant amount of change in its financial statements, information systems, risk management programs and, potentially, product design. Once these changes are made, there will also need to be an education of all stakeholders in the process, including shareholders, policyholders and analysts. The relationship between IFRS profits and reserves and those computed for solvency and tax purposes will also need to be considered further, taking into account potentially different systems and data requirements as well as potential differences in tax cash flows.

Despite all of this, the end result will hopefully bring consistency, comparability and transparency across insurance companies and allow the whole industry to benefit from more straightforward access to capital markets.

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