Insurance Accounting Newsletter
Insurance accounting taking shape

The publication of the long awaited Exposure Draft (ED) on insurance accounting is fast approaching, with an expected issue date of May 2010. In an effort to meet the deadline, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have set up additional joint meetings, one of which took place on the 10 February, along with the planned joint meeting which took place on the 18 February.

The issue of unbundling was discussed although unfortunately, an agreement between the Boards could not be reached. Convergence seems to be more likely on the issues of accounting for reinsurance, the presentation of the performance statement and unit-linked and separate accounts contracts. Our newsletter this month details the discussions that took place and the tentative decisions reached. It should be noted that one member of FASB was absent at the 18 February meeting and therefore, only four FASB members voted.

Financial statement presentation

At their three hour long meeting on the 18 February, the Boards discussed the presentation of insurance contracts in the statement of comprehensive income. The IASB and the FASB agreed that the measurement approach should drive the presentation model for the performance statement, as recommended by the Staff (IASB – 13 in favour, 2 against; FASB – 4 in favour, 0 against). The proposal from the Staff is for the performance statement to display at least the following information:

- the release of the residual margin and the expected risk adjustment during the period;
- the difference between expected and actual cash flows;
- changes in estimates; and
- results from investments, i.e. interest income and the unwind of discounting of the insurance liability.

Three examples of presentation were tabled by the Staff:

a) a summarised margin presentation;

b) an expanded margin presentation; and

c) a "traditional" premium allocation presentation.

The Boards agreed that they should not select a "traditional" premium allocation approach as the presentation model for all types of contracts. Contracts required to be measured using the unearned premium method (e.g. certain non-life contracts) would be the only ones where a "traditional" presentation may be used as a basis for the presentation of this simplified measurement approach.

The Boards agreed that all three approaches would be included in the forthcoming ED. However, the IASB expressed a strong preference for the "expanded margin" presentation approach (9 in favour), while the FASB preferred the "summarised margin" approach (all 4 members in favour). This difference in the application of a common principle is unlikely to be an obstacle to the finalisation of the ED and we believe that both approaches could be retained as the two applications possible under the new IFRS.

The difference in opinion here is more to do with the amount of information that would be presented on the face of the performance statement as opposed to model itself, which remains with a focus on a margin approach.

The FASB asked the Staff to research for a future meeting the disclosure of the "key business drivers" that would derive from this presentation principle.

To illustrate what the Staff proposed, we have included above some examples as presented in the observer notes from the IASB.

Example 1. Summarised margin presentation

	Inception 1 Jan	six months to 30 Jun	six months to 31 Dec
Risk adjustment		21	26
Residual margin		13	13
Insurance margin	0	33	39
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Acquisition costs	0		
Net gain at inception	0	0	0
Investment income		40	38
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	15
Profit	0	19	44

Source: IASB Paper 14E – meeting of 18 February 2010

From the above example, it is clear that there is a strong focus on the three building blocks under the proposed measurement approach. As well as showing the release from the residual margin and from the risk adjustment, the statement shows the experience adjustments arising from actual cash flows being different from their estimates. The example also illustrates that, possibly as a consequence of experience being worse than anticipated, assumptions are changed to reflect new and current expectations, translating in a cost in the changes in estimates line. The example shows a nil impact from acquisition costs however, if there had been any costs it would have shown a negative number to reflect the fact that they are expensed as incurred. The investment margin section of the performance statement shows the assets' return against the interest expense from unwinding of the market consistent discounting of the insurance liability, i.e. block 2 in the building block model.

Example 2. Expanded margin presentation

	Inception 1 Jan	six months to 30 Jun	six months to 31 Dec
Revenue		123	125
Policyholder benefits		(50)	(65)
Expenses		(40)	(40)
Release of benefits and expenses accrued in previous periods		0	20
Insurance margin		33	39
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Acquisition costs	0		
Net gain at inception	0	0	0
Investment income		40	38
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	15
Profit	0	19	44

Source: IASB Paper 14E – meeting of 18 February 2010

The second example shows the presentation using an expanded margin approach. Below the "insurance margin" line, all the information is the same as for the summarised margin approach and is similarly focused on the three building blocks. The key difference here is the emphasis on the performance statement elements of revenue, benefits paid, expenses and releases from previous periods. These additional lines link back to the traditional presentation model.

The staff noted that there are several alternatives for an expanded margin approach. The example provided by the Staff illustrates an approach that reports revenue equal to the customer consideration for services (excluding maturity benefits) and the estimated costs for policyholder benefits and expenses.

Both presentations offer similarities with certain embedded value reporting practices.

Looking back at the proposed summarised margin presentation of the performance statement, each building block operates as follows:

- From block 1, the experience variances replace the premium income and the claims/benefit expenses lines, whilst the total change in estimates (inclusive both of changes in margins and cash flows estimate) is shown separately from experience variances as a cost or income line.

- From block 2, the investment margin section includes the unwinding of the insurance liability discount compared against the investment income from the assets held. The changes in the market rates impacting the level of the market consistent discount rate would be reflected separately although this was not covered specifically at the meeting.

- From block 3, the release from risk is shown as income based on the previous reporting period expectations of risk release. This approach separates this element from the changes in the estimated risk margin, which is instead included in the changes in estimates line together with the changes from block 1.

Reinsurance contracts accounting

The discussions around the subject of reinsurance accounting, although important, were fairly uncontroversial and the proposals from the Staff were largely agreed upon by both Boards. The first question the Staff asked the Boards was whether reinsurers should use the same recognition and measurement principles for the reinsurance contracts they issue as insurers use for the insurance contracts they issue. Although members of the Boards accept that in practice this principle may produce different accounting values for insurers and reinsurers (particularly for non-proportional reinsurance) because of the absence of symmetry between policy terms and information available to insurers and reinsurers, they still unanimously voted in favour of the Staff recommendation.

The second recommendation relating to the measurement and recognition of reinsurance assets was also unanimously approved by the Boards although this time, with three important caveats. The Staff recommended that the cedant should recognise and measure its reinsurance asset using the same measurement and recognition principles it uses to measure and recognise the reinsured portion of the underlying insurance contracts it has issued. This would include the following items:

- blocks 1 and 2 for the reinsured portion of the liability;

- the risk adjustment from the reinsured portion of the liability;

- a residual margin, calibrated to the reinsurance premium; and

- the impact of possible impairment and coverage disputes.

The effect of a residual margin in the reinsurance measurement by the cedant is to eliminate a day 1 result on purchase of a reinsurance contract or cession of risks to an existing reinsurance contract. Some members were not clear as to why the measurement should include a residual margin and/or how it should be calculated. The Staff explained that the residual margin applicable to the reinsurance asset would be calibrated using the reinsurance premium paid, whereas all the other items would be calculated as the reinsured proportion of the relevant insurance contracts (i.e. in the case of proportional reinsurance the % of block 1 & 2 + the % of risk adjustment). The Staff noted that the issue of a negative residual margin upon calibration of a reinsurance asset (i.e. when the calculated three building blocks are higher than the premium paid to the reinsurer – a day one reinsurance gain) has not yet been addressed and it will be brought back for discussion at a future meeting.

Board members agreed that the reinsurance asset must be tested for impairment on a prospective basis allowing also for losses not yet incurred (expected loss basis). Some queried whether any day 1 impairment should be reflected as an adjustment to the residual margin or the first two building blocks (present value of expected future impairment losses).

The unanimous vote in favour of the Staff recommendation was therefore accompanied by three caveats, requesting the Staff to:

1. reconsider the issue of a negative residual margin (i.e. where expected recoveries exceed expected premium on day 1);

2. reconsider the wording for impairment and in particular the interaction of the building blocks and prospective impairment testing; and

3. provide numerical examples illustrating the proposed measurement for both the cedant and reinsurer.

The Boards unanimously agreed with the recommendation not to offset reinsurance balances against related reinsured balances, unless requirements for offsetting are met as set out in IAS 1 and IAS 32. This effectively maintains the gross presentation we are used to under IFRS 4 Phase I where there is no netting of reinsurance balances against related reinsured balances.

On the subject of derecognition, once again, both Boards were unanimously in favour of the Staff recommendation that reinsurance should not result in derecognition of the related reinsured insurance liabilities unless the obligation specified in the insurance contract is discharged, cancelled or expired.

A more intense debate was triggered when the treatment of ceding commissions was discussed. The Staff recommendation is that ceding commissions should be credited/charged to the performance statement by both the cedant and reinsurer in the same manner as the cedant's acquisition costs. The proposed treatment would apply regardless of the fact that the ceding commission may not be paid to a third party. This would mean that ceding commissions would be accounted for as income on day one and they could reduce the accounting loss arising from calibrating the initial measurement of the liability to the gross premium with all acquisition costs taken through income as expenses.

Board members noted concerns on the practicalities of applying this principle to non-proportional contracts where there is no direct link between the acquisition costs and ceding commission. Therefore, the Staff recommendation was amended to include only proportional reinsurance contracts for which a direct link exists between acquisition costs and ceding commissions. The principles to be applied to non-proportional reinsurance contracts will be discussed at a later meeting.

Although both Boards voted unanimously in favour of the Staff recommendation, some FASB members expressed concerns regarding the "anchoring" of ceding commission in proportional reinsurance contracts to acquisition costs incurred on the underlying business reinsured.

In particular FSAB members noted concerns that ceding commission may recompense cedants for administration costs not just acquisition costs, that the determination of ceding commission as an allocation of overall contract consideration may be arbitrary, and that there may not be a clear link between ceding commission and acquisition costs on long term contracts reinsured some time after the acquisition costs are incurred.

On the back of previous tentative decisions, the recommendation that there should be symmetry of measurement principles between the cedant's reinsurance asset, its underlying insurance liability and the reinsurer's liability (except in relation to the credit risk of the reinsurer) was deemed approved by both Boards.

Our closing comment on this debate is that the decision to calibrate gross of acquisition expenses has now received an indirect criticism from the discomfort that the Boards have when they see the application of the same principle to reinsurance assets produces the very result they tried to avoid: "revenue" at the inception of a contract. IASB and FASB have planned to discuss the issue of day one accounting loss at their March meetings.

Unbundling and embedded derivatives

Unfortunately, the Boards again failed to achieve convergence on the subject of unbundling and embedded derivatives – which will be treated as one subject from now on. The IASB re-affirmed for a third time its support for the unbundling model as proposed by the Staff, which in summary includes the following key principles:

- unbundling should be required when insurance and other components of a contract are not interdependent;
- unbundling should be prohibited in all other cases;
- the deposit component, when not unbundled, should not be separated in the presentation of the performance statement; and
- embedded derivatives do not need special rules for bifurcation.

The only principle on which both Boards agreed was the fourth one, i.e. accounting for embedded derivatives will be under the same regime as other non insurance components of an insurance contract. The Staff introduced the technical discussions by noting that the IASB and FASB staffs were split on the issue and that a minority thinks an alternative unbundling model could be developed by revising the principle of interdependence developed by the majority of members of Staff.

The alternative view on unbundling is that interdependence only arises for those contracts where a truly symbiotic relationship is necessary for the components to function. Therefore components of an insurance contract that can function separately should be unbundled. The alternative view concludes that contracts with an explicit policyholder balance (such as universal life type contracts or variable and unit linked contracts) should be unbundled as they are essentially investment contracts with an insurance rider.

The Boards had an extended debate on the issues presented but did not conclude on a particular approach.

Having failed to reach an agreement on the key principles, the Boards concluded that there would be a new effort from the Staff to better define interdependence.

In order to facilitate a more constructive debate at a future meeting, the Staff agreed to develop illustrative examples of how the interdependence concept would apply in practice to various types of contract, focusing on contracts where the determination of interdependence may be uncertain.

No decision was taken on the important matter of unbundling although there is a clear sense of commitment from both Boards to work towards a common solution.

Variable and unit-linked contracts – separate accounts

The Boards discussed the accounting for account-driven contracts generically referred to as 'unit-linked' or 'variable annuity' contracts. In particular, they considered questions about whether the invested fund into which the premium is deposited represents an asset and corresponding liability of the insurer.

In line with current US GAAP and IFRS, the Boards agreed that that assets and related liabilities associated with unit linked contracts, (including separate account contracts), should be reported as the insurer's assets and liabilities in the statement of financial position (IASB – 10 in favour, 5 against; FASB – 4 in favour, 0 against).

Following some debate, the Boards agreed that that issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts) should be addressed in the consolidations project rather than in the insurance contracts project (IASB – 13 in favour, 2 against; FASB – 4 in favour, 0 against).

Policyholder accounting

The Boards discussed how policyholders should account for insurance contracts at the special meeting on 10 February. Overall, the Staff proposed that the building blocks model can, subject to additional research and guidance to be drafted, be applied by policyholders. Several issues were highlighted, but only two require further consideration in the context of insurer accounting: the expensing of acquisition costs; and participating rights. Staff will prepare further papers on these two subjects. The two Boards agreed unanimously, not to include policyholder accounting in the upcoming ED, but to include it in the final standard.

Timetable and next steps

Despite two long meetings to discuss insurance in February, the Boards did not manage to address all the issues that had been tabled. In particular they did not discuss or vote on the following items:

- recommendation that unit-linked contracts should be measured in the same manner as other account-driven contracts;
- recommendation that an insurer should not be prohibited from presenting unit linked assets as a separate line in the statement of financial position;
- recommendation that if presented separately from other liabilities, the unit linked liability should include all of the insurer's obligations under the contract and should not only be a mirror image of the asset account balance;
- whether there could be solutions in line with the IFRS and US GAAP conceptual frameworks to eliminate asset-liability measurement mismatches in the accounting of unit-linked contracts; and
- field testing results.

Several significant issues discussed in February but not resolved will be reconsidered at subsequent meetings and the March calendar is full of insurance meetings. These will cover among other issues:

- unbundling application guidance (including its specific application to universal life and other account driven contracts) and illustrative examples for determining interdependence;
- ceding commission principles for non-proportional reinsurance contracts;
- anchoring of ceding commission to related acquisition costs; and
- reinsurance accounting by cedants for negative residual margin and impairment.

The Boards intend to meet at least twice a month until the publication of the ED which is still aimed for May 2010 and remain committed to delivery of the insurance accounting standard no later than June 2011.

During March, insurance accounting will be discussed in several meetings; these will all be joint discussions between the two Boards:

- 15 March
- 16 March
- 17 March
- 22 March
- 23 March
- 24 March

Appendix. Summary of tentative decisions to date

Converging tentative views	IASB & FASB
Measurement objective and approach	Current assessment of the insurer's obligation using four building blocks: • the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation; • incorporation of time value of money; • a risk adjustment for the insurer's view of the effects of uncertainty about the amount and timing of future cash flows; and • an amount that eliminates any gain at inception of the contract.
Measurement approach	The measurement approach will be applied to the overall insurance contract to produce one carrying amount inclusive of all rights and obligations rather than separate asset and liability components.
Measurement objective	The measurement objective will refer to the value rather than the cost of fulfilling the obligations under the insurance contract. The Staff is to propose further refinement of the measurement objective wording.
Risk adjustment	The risk adjustment is defined as the amount the insurer requires for bearing the uncertainty about the resources it will require to fulfil the remaining net obligation from insurance contracts. The risk adjustment will be remeasured at each reporting date.
Service margin	No explicit service margin is included in the measurement approach.
Use of inputs for measurement	All available information relevant to the contract should be used. Current estimates of financial market variables must be as consistent as possible with observable market prices.
Non performance risk	Prohibition from taking changes in the insurer's non-performance risk (including own credit risk) into account in subsequent measurement of the insurance contract.
Accounting profit	Prohibition from recognising accounting profit at initial contract recognition.
Negative day one differences	Recognise negative day one difference immediately as a day one loss. Further discussion planned to establish the appropriate unit of measurement.
Acquisition costs accounting	Expense as incurred through the income statement.
Revenue Recognition on Day 1	No revenue recognised at initial measurement since the liability is calibrated to the gross premium received from the policyholder.
Policyholder accounting	Policyholder accounting (other than by cedants) will not be included in the Exposure Draft but will be included in the insurance accounting standard.
Presentation	Rejection of a model that recognises revenue on the basis of written premiums. Revenue will be recognised as the insurer performs under the contract). The insurance contract will be presented as a net amount inclusive of all rights and obligations rather than separate asset and liability components.
	Performance statement presentation should include at least the following information: • release of expected margins during the period; • difference between actual and expected cash flows; • changes in estimates; and • results from investments (interest income and unwind of discount on the insurance liability). Both the summarised margin and expanded margin approaches will be included in the Exposure Draft. A traditional premium allocation approach may only be used for insurance contracts required to be measured under the unearned premium approach.
Policyholder behaviour	Expected cash flows from options, forwards and guarantees relating to the insurance coverage (e.g. renewal and cancellation options) are part of the contractual cash flows rather than a separate contract or part of a separate customer intangible asset. Measurement of these options will be based on a "look through" approach when reference to standalone price is not available. All other options guarantees and forwards not relating to the existing insurance coverage will form part of a separate contract that will be accounted for according to the terms of that separate contract.
Deposit floor	The first building block will include all the cash flows arising from the cancellation or the renewal options, i.e. no deposit floor.
Subsequent treatment of margins	The Staff is to determine and recommend a simple mandatory basis for the release of residual margins. The Boards rejected the recommendation previously tentatively agreed by the IASB that the residual margin be released over the coverage period, on a systematic basis, as determined by the insurer, that best depicts the insurer's performance under the contracts. The release of residual margin to profit will be independent of changes in the value of estimates within the three-building-blocks.

Recent changes

Converging tentative views	IASB & FASB
Reinsurance	Reinsurers to use same measurement principles as for insurers. Cedants should measure reinsurance assets using the same principles used to measure the reinsured liability. The Boards will consider further the accounting by cedants for residual margins and impairment of reinsurance contracts. Reinsurance assets should not be offset against insurance liabilities unless the legal requirements are met. Reinsurance should not result in derecognition of insurance liabilities unless the obligation has been discharged, cancelled or expired. The cedant and reinsurer should account for ceding commissions on proportional reinsurance in same manner as the cedant's related acquisition costs. The Boards will consider further the anchoring of ceding commission to acquisition costs and accounting for ceding commission on non-proportional reinsurance contracts.
Unbundling	For recognition and measurement, an insurer should: • unbundle a component of an insurance contract if it is not interdependent with other components of that contract; • not unbundle a component that is interdependent. However, the Boards have not agreed on a definition of interdependence and have requested that the Staff prepare unbundling application guidance to include a revised definition of interdependence (including its specific application to universal life and other account driven contracts) and illustrative examples for determining interdependence. If unbundling is not required for recognition and measurement, it should not be a permitted option. Embedded derivatives within an insurance contract should be subject to the same unbundling requirements as other components of the insurance contract.
Variable and unit linked contracts	The associated assets and liabilities should be reported as assets and liabilities of the insurer in the statement of financial position. Consolidation of investment funds will be addressed in the consolidation project.

Divergent tentative views	IASB	FASB
Insurance contracts with participation features	Cash flows from participation features should not be measured separately from the host insurance contract and they should be part of the overall expected cash flows of that contract.	Participation features should only be classed as liabilities when they meet the definition of a liability, particularly in relation to whether there is a legal or constructive obligation to pay.
Recognition	The IASB declined to make a final decision on recognising insurance contracts. The staff are to provide additional analysis at a later meeting.	An insurance obligation should be recognised at the earlier of (1) the entity being on risk and (2) the signing of the insurance contract.
Derecognition	Derecognition of insurance liabilities should follow the IAS 39 criteria.	An insurance liability should be derecognized when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.
Presentation	Performance statement presentation should follow the expanded margin approach, either based on the premium paid or the part of the premium paid for services.	Performance statement presentation should follow the summarised margin approach.

Recent changes

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

■ Recent changes

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