

Insurance Accounting Alert

IASB and FASB continue to discuss significant issues to complete deliberations on insurance contract accounting

Overview

This month, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (collectively, the Boards) will again devote a significant amount of time to the discussion of insurance contracts. They aim to come to tentative decisions on a number of significant items in order to issue an Exposure Draft of the new standard in June 2010.

Discussions scheduled in April 2010 are as follows:

Wednesday 21 and Thursday 22 April 2010	Margins and disclosures
Friday 23 April 2010	Level of measurement

These discussions are likely to determine some of the significant components of a new standard. The progress made in resolving open questions will determine whether the timetable for release of the Exposure Draft remains realistic. April 2010 is another important month for insurance reporting.

Please note that due to the ongoing travel disruption, further changes to the agenda may be made at short notice.

The story so far

A summary of topics discussed and tentative decisions by the Boards are set out in the table below.

Topic	IASB	FASB
Definition	<p>The Boards tentatively decided to use the current definition of an insurance contract in IFRS 4 <i>Insurance Contracts</i> and the related guidance in Appendix B of IFRS 4. Specifically that:</p> <ul style="list-style-type: none"> ▶ Compensation rather than indemnification be used in the definition of an insurance contract in describing the benefit provided to the policyholder. ▶ The guidance in IFRS 4 should be used in determining whether insurance risk is significant, subject to issues discussed below. 	
Definition - timing risk	<p>On timing risk, the Boards decided tentatively to:</p> <ul style="list-style-type: none"> ▶ Change the factors considered in evaluating the significance of insurance risk from absolute amounts to present values. ▶ Amend the guidance in IFRS 4 to explain that contractual terms that delay timely reimbursement to the policyholder can significantly reduce insurance risk, so that some contracts containing such terms might not meet the definition of an insurance contract. 	
Definition - assessment of possible outcomes	<p>For determining when insurance risk exists, the IASB expressed an initial preference for considering the range of possible outcomes.</p>	<p>For determining when insurance risk exists, the FASB expressed an initial preference for considering whether there are outcomes in which the present value of the net cash outflows can exceed the present value of the premiums.</p>
Scope	<p>The Boards tentatively decided that the scope of a standard on insurance contracts will exclude:</p> <ul style="list-style-type: none"> ▶ Warranties issued directly by a manufacturer, dealer or retailer ▶ Residual value guarantees embedded in a lease ▶ Residual value guarantees provided by a manufacturer, dealer or retailer ▶ Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans ▶ Contingent consideration payable or receivable in a business combination <p>The Boards expressed an initial preference that the scope of the standard should exclude fixed-fee service contracts, but noted that it would be undesirable to exclude contracts merely because they pay benefits in kind rather than in cash. The Boards will consider this initial preference at a future meeting at which they will discuss whether to include health contracts within the scope of the standard.</p> <p>The Boards will also discuss at a future meeting, whether financial guarantee contracts should be within the scope of the standard.</p>	
Recognition	<p>The IASB discussed the recognition of rights and obligations arising under insurance contracts, including the treatment of the contract in the period (if any) between entering into the contract and the start of the coverage period. No clear consensus emerged. However, the Boards will return to the topic of recognition at their April meeting.</p>	<p>The FASB tentatively decided that an entity should recognise an insurance obligation at the earlier of: (1) the entity being on risk to provide coverage to the policyholder for insured events; and (2) the signing of the insurance contract.</p>
Derecognition	<p>The IASB discussed derecognition of insurance liabilities and decided tentatively that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principle in: IAS 39 <i>Financial Instruments: Recognition and Measurement</i>.</p>	<p>The FASB tentatively decided on a principle that an insurance liability should be derecognised by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.</p>

Topic	IASB	FASB
Measurement approach	<p>The Boards decided tentatively that the measurement approach should portray a current assessment of the contract, using the following building blocks:</p> <ul style="list-style-type: none"> ▶ 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 margin. (The IASB and FASB reached different tentative positions on margins during the March joint meeting) <p>The Boards also tentatively decided that:</p> <ul style="list-style-type: none"> ▶ The building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations. That combination of rights and obligations should be presented on a net basis. ▶ The objective for measuring an insurance contract should refer to a value rather than cost. The Staff will refine the description of that objective. 	
Measurement approach – decomposition of margins	<p>The IASB decided tentatively that the measurement of an insurance contract should include:</p> <ul style="list-style-type: none"> ▶ A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows. ▶ An amount that eliminates any gain at inception of the contract (residual margin). <p>The IASB decided tentatively that the risk adjustment should be the amount the insurer would rationally pay to be relieved of the risk.</p>	<p>The FASB decided tentatively that the measurement of an insurance contract should include one single composite margin. (The Staff are developing this approach further for discussion at the April joint meeting.)</p>
Measurement at inception	<p>The Boards decided that:</p> <ul style="list-style-type: none"> ▶ The initial recognition of an insurance contract should not result in the recognition of an accounting profit. ▶ If a loss should arise at inception because the residual margin or composite margin cannot be negative, the insurer should recognise that loss in profit or loss at inception. Such losses will be less frequent, and smaller, in the composite margin approach than in the approach that uses a risk adjustment with a residual margin. <p>(The Boards will discuss at their April joint meeting how to apply their tentative decisions on measurement at inception to composite margins.)</p>	
Acquisition costs	<p>The IASB decided tentatively to exclude from the initial measurement of the residual margin an amount equal to the incremental acquisition costs. The Staff will investigate whether that tentative decision is best implemented by:</p> <ul style="list-style-type: none"> ▶ Excluding the acquisition costs from the premium to which the contract liability is calibrated. ▶ Including the acquisition costs in the contract cash flows at the inception of the contract. 	<p>The FASB decided tentatively that an insurer should:</p> <ul style="list-style-type: none"> ▶ Expense all acquisition costs when incurred. ▶ Not recognise any revenue (or income) to offset those costs incurred.

The story so far (continued)

Topic	IASB	FASB
Subsequent treatment margins	<p>The Boards decided tentatively that, if the measurement of an insurance contract were to include a separate risk adjustment and residual margin:</p> <ul style="list-style-type: none"> ▶ The risk adjustment should be updated (remeasured) each reporting period. ▶ The insurer should release the residual margin over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows: <ul style="list-style-type: none"> ▶ On the basis of passage of time; but ▶ If the insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time, the residual margin should be released on the basis of the expected benefits and claims. <p>The Boards also decided tentatively that the insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates.</p> <p>(The Boards will discuss the subsequent treatment of composite margins at their April joint meeting.)</p>	
Discount rates	<p>The IASB decided tentatively that:</p> <ul style="list-style-type: none"> ▶ The discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on actual assets backing those liabilities, ▶ The standard should not give detailed guidance on how to determine the discount rate. 	<p>The FASB will discuss the discount rate further at this meeting.</p>
Exclude discounting and margins in some instances	<p>The IASB noted the arguments for and against an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB considered whether to use such an approach for non-life claims liabilities and tentatively decided not to add it to the list of candidates.</p>	<p>The FASB will consider at a future meeting whether, in certain instances, a measurement of insurance contracts would use future cash flows with no margins and no discounting.</p>
Participating features in insurance contracts	<p>The IASB decided tentatively that payments arising from the participating feature should 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).</p>	<p>The FASB decided tentatively that the insurer should recognise a liability for participating benefits to the extent that it has a legal or constructive obligation to pay those benefits.</p>
Non-performance risk	<p>The Boards decided tentatively that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer.</p>	
Use of inputs	<p>The Boards decided tentatively that the measurement should:</p> <ul style="list-style-type: none"> ▶ Consider all available information that relates to the fulfilment of the insurance contract. Available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract. ▶ Use current estimates of financial market variables that are as consistent as possible with observable market prices. 	
Unearned premium	<p>The IASB decided tentatively:</p> <ul style="list-style-type: none"> ▶ An unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts. ▶ To require rather than permit the use of an unearned premium approach for those liabilities. 	<p>The FASB will discuss an unearned premium approach at a future meeting.</p>

Topic	IASB	FASB
Policyholder behaviour and contract boundaries	<p>The Boards decided tentatively that the policyholder options, as well as options, forwards, and guarantees related to existing coverage, should be included in the measurement of the insurance contract on a look-through basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract). As a consequence, no deposit floor would apply. The Staff have developed a proposal to identify the boundary of an existing contract, which will be discussed at the April meeting.</p> <p>The Boards also discussed how to treat options, forwards, and guarantees that do not relate to the existing insurance contract coverage. The Boards tentatively decided to exclude such features from the measurement of that contract. Instead, those features should be recognised and measured as new insurance contracts or other stand-alone instruments, according to their nature.</p>	
Assets associated with unit-linked contracts	<p>The Boards decided tentatively that assets and related liabilities associated with unit-linked contracts, including those sometimes described as separate accounts, should be reported as the insurer's assets and liabilities in the statement of financial position.</p> <p>The Boards also decided tentatively not to address in this project issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts). Such issues are within the scope of the project on consolidation.</p>	
Presentation of the performance statement	<p>The Boards decided tentatively that:</p> <ul style="list-style-type: none"> ▶ The measurement approach should drive the presentation model for the performance statement. ▶ The Staff should develop further an expanded margin approach. 	
Other Comprehensive Income (OCI)	<p>The Boards decided tentatively:</p> <ul style="list-style-type: none"> ▶ Not to change the accounting for an insurer's assets. ▶ Not to permit or require the use of OCI for insurance contracts. 	

Source: IASB Staff Paper 3, Ernst & Young.

Margins

The Staff will present two separate papers (Agenda Papers 3A and 3B) on potential approaches to margins: one on the inclusion of both risk and residual margins (favoured by the IASB); and another on composite margins (favoured by the FASB). The Staff will not ask the Boards to make a decision on which measurement approach should be used until the extra board meeting in May to allow for appropriate time for the Boards to consider the two approaches.

Risk adjustments

The primary difference between the two approaches is the identification of an explicit risk adjustment under the risk and residual margin approach, while the risk adjustment is implicit in the composite margin.

Explicit risk adjustment in the risk margin

The objective for the risk adjustment is defined as “the amount the insurer would rationally pay to be relieved of the risk” and is intended to convey information about the uncertainty in the remaining cash flows.

The Staff provided detail regarding the characteristics that, to the extent possible, should be included in the explicit risk adjustment:

- ▶ The less that is known about the current estimate and its trend, the higher the risk adjustment.
- ▶ Risks with low frequency and high severity will have higher risk adjustments than risks with high frequency and low severity.
- ▶ For similar risks, long duration contracts will have higher risk adjustments than those of shorter duration.
- ▶ Risks with a wide probability distribution will have higher risk adjustments than those risks with a narrower distribution.

The Staff also recommended that the approach for determining risk adjustments consider key factors such as the technique, risks considered and practicality of the approach. The Staff identified seven alternative classes of risk methodologies for consideration but suggest that cost of capital (with reference to economic capital versus regulatory capital) and quantile methodologies (such as conditional tail expectation) are most appropriate, while explicit assumption, discount rate, stress/sensitivity, stochastic modelling and market calibration methods would not meet the objective as set out in the first paragraph above (descriptions of the methodologies are summarised in Agenda Paper 3A).

Finally, the Staff presented an alternative that would require translation of the methodology used for measurement into one common benchmark methodology to provide comparability amongst insurers. The Staff suggested that insurers could be required to translate the methodology used into a confidence interval or disclose the risk adjustment as an absolute amount and percentage of the expected present value of remaining cash flows. However, no recommendation has been made by the Staff on this topic.

Implicit risk adjustment in the composite margin

While the residual and composite margin are similar in many ways (as set out in the table), they differ primarily due to the implicit inclusion of a risk margin in the composite margin. As the composite margin includes an implicit risk margin, the release of the composite margin may be more complex than simply the passage of time as with the residual margin (refer below). The Staff identified specific potential drivers for release of the composite margin (or performance under the contract) that include, but are not limited to:

- a. Release from risk
- b. Funds under management
- c. Expected benefit and claim payments
- d. Premium receipts
- e. Passage of time
- f. A mix of two or more

The Staff also identified a specific method that is a combination of c) and d) above, which would require adding the absolute value of actual premiums, claims and benefits by the absolute value of expected premiums, claims and benefits, using the resulting percentage as the amount of composite margin to release.

Residual and composite margins

The table below summarises the recommendations of the Staff with respect to residual and composite margins.

	Residual margin	Composite margin
Definition	The difference between: a) the expected premiums (IASB premiums less acquisition costs); and b) the expected claims and expenses plus a risk adjustment.	The product of a calibration that eliminates the day-one difference between: a) the expected premiums; and b) the expected claims, benefits and claims handling expenses.
Part of the insurance liability or separate liability	The residual margin is part of the insurance liability.	The composite margin is part of the insurance liability.
Release criteria	The residual margin should be released in a systematic way. The Boards have tentatively decided that the release criteria should best reflect the exposure from providing coverage on passage of time, unless the expected pattern of claims and benefits differs significantly from passage of time. In which case, release should be based on claims and benefits as expected at inception.	The composite margin should be released in a systematic way. Some Staff recommended that release is based on a driver (or drivers) that best depicts performance under the contract (refer above). Other Staff recommended release is based on the insurer's exposure from providing insurance coverage and uncertainties related to future cash flows. The allocation can be adjusted over time if expectations change significantly, but as an adjustment, not a remeasurement.
Release period	Released over the coverage period.	The period of release follows from the drivers determined above.
Accretion of interest	Some Staff recommended that interest be accreted on the residual margin, while others recommended not accreting interest.	Some Staff recommended that interest be accreted on the composite margin, while others recommended not accreting interest.
Separately disclosed	Residual margins should be separately disclosed.	Composite margins should be separately disclosed.

Discount rate

Despite some divergent views, the Staff recommended that the objective for the discount rate of insurance contracts should reflect the characteristics of the rights and obligations from the insurance contract and should not include characteristics of the assets held to back the insurance liability unless the liability shares those characteristics.

Under this approach, the discount rate for non-participating contracts should capture the characteristics of the liability only, which generally include timing, duration and currency. These Staff members acknowledge, however, that liquidity is an additional characteristic of the liability, and where relevant, should be taken into account when determining the discount rate. Agenda Paper 3D provides discussion of applying and calculating liquidity premiums, which the Staff points out is still controversial and complex.

Other Staff members will recommend that, for comparability reasons and for consistency with pension accounting, a discount rate described as high-grade corporate debt should be required for both participating and non-participating contracts. These Staff members may agree with the concept of liquidity, but favour the less complex and more comparable approach of using a particular observable market rate or a set of observable market rates.

The discount rate for a participating contract receives less focus in Agenda Paper 3D. The Paper states that the contract liability should be based on the characteristics of the liability, but may also take into consideration that the amount, timing and certainty of the contract's cash flows will at least partially depend on the performance of the assets backing those liabilities. The Staff suggested that the easiest way to estimate the discount rate is to consider the notion of a replicating portfolio, but the simple use of an asset-based discount rate is not appropriate.

Based on the earlier tentative decisions, under either approach, the discount rate should not reflect the risk of non-performance by the insurer. The most practical way to do so is to exclude it from the discount rate, effectively including it in the residual or composite margin at inception.

The Staff will not recommend that the Boards provide specific guidance on how to estimate a discount rate for insurance liabilities. Instead, the Staff believe that the Boards should cross-reference the guidance on fair value measurements currently set out in FASB Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures* (ASC 820) and IAS 39 *Financial Instruments: Recognition and Measurement* (expected to be replaced in 2010 by *Fair Value Measurement*).

Contract boundaries

In May 2009, the IASB tentatively determined the boundary between existing and new contracts as the point at which the insurer can cancel the contract or change the pricing or other terms.

In a departure from the 'guaranteed insurability' concept in the Discussion Paper, the Staff will recommend that the contract boundary is defined as including all cash flows arising under the contract as a result of events occurring during the period ending on the earlier of:

- ▶ The contract coverage period (as extended by any renewal options available to the policyholder).
- ▶ The point at which the insurer has an unrestricted ability to cancel or re-underwrite and re-price coverage of the individual contract. For this purpose, restrictions would be ignored if they have no commercial substance.

The contract boundary definition specifically includes both the terms 're-underwrite' and 're-price' as both are required to result in a 'new' contract. Individually, each of these may occur, but not result in a significantly different contract. Re-underwriting without the ability to re-price provides a policyholder with value (i.e., continuing insurance under unchanged terms) under the existing contract. Similarly, re-pricing without re-underwriting may result from general changes (e.g., mortality experience) that would apply to all policies.

The Staff recommend that the boundary principle should be applied at the individual contract level and that a group contract is considered a single contract between insurer and employer. The Agenda Paper also points out that the insurer's ability to re-underwrite and re-price must be unrestricted. For this purpose, restrictions would be ignored if they have no commercial substance.

Recognition

In November 2009, the FASB tentatively decided that an entity should recognise an insurance obligation at the earlier of 1) the entity being on risk to provide coverage to the policyholder for insured events, or 2) the signing of the insurance contract. The IASB did not reach a conclusion at that meeting, but the Staff will recommend that the IASB adopt the definition tentatively adopted by the FASB.

Key to the consideration above is the definition of 'on risk', which does not necessarily refer to the coverage period and can be prior to the start of the coverage period (e.g., the point at which the insurer is not able to withdraw from an obligation to provide insurance cover).

In Agenda Paper 11, the Staff explore two potential alternatives to measuring the insurance liability during the period between becoming party to a contract (or being 'on risk') and the start of the coverage period. These alternatives would be to either record any premium received during this period as a deposit or treat the entire contract as a derivative during this period. Ultimately, the Staff conclude that neither of these alternatives are viable and retain the decision noted above.

Timetable for Boards discussion

The insurance Exposure Draft is still expected to be published in June 2010, with comments due by October 2010. The majority of open issues, including unbundling, unearned premium approach, scope, receivables related to acquisition costs, reinsurance and disclosures will be discussed by the Boards at their joint meetings in May 2010.

Follow the discussion

Accounting for insurance contracts is scheduled to be discussed by the IASB and FASB on the following dates and times in April:

- ▶ Wednesday 21 April 13:00-17:30 GMT
- ▶ Thursday 22 April 14:15-16:15 GMT
- ▶ Friday 23 April 09:00-11:00 GMT

You can register to follow the discussion at www.iasb.org.

Area IFRS insurance contacts

We welcome your feedback on *Insurance Accounting Alert*.

Please get in touch with your local Ernst & Young insurance contact with any enquiries.

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