Accounting Developments – Update Note No. 7
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Background
This is the seventh in a series of Notes covering the deliberations of the IASB on the issue of an insurance standard to replace IFRS 4. This note covers meetings from 31 May/1 June 2011 to end December 2011. The IASB also met in February 2012 (notes from this meeting are not currently available from the IASB although some high level comments have been included in this note) and held an education session in January 2012. The next meeting to discuss the development of the standard is to be held in the week commencing 19 March 2012.

The Note has also been expanded to provide a brief overview of other relevant accounting developments for insurers.

New team
We are delighted to welcome Anthony Coughlan (PricewaterhouseCoopers) and Raymond Bennett (KPMG) to the team who prepare this note for the Actuarial Profession. Peter Wright is standing down from this role and we would like to thank him for his significant contributions over the years.

Timetable
A review draft or a revised Exposure Draft (ED) is expected in the second half of 2012. The IASB has not provided any further details on the timeline and there is no public indication of when the standard will be finalised or implemented (although there is general agreement that a suitable transition period will be necessary). The previously stated target implementation date of 1 January 2015 is looking less likely due to the delays in the project and the potential issues with the desire for convergence with the FASB insurance standard (considered in a subsequent section).

At a glance … Insurance standard – High level overview
At a glance, the most significant tentative decisions made by the IASB are:
- No gains at inception (see Note 6)
- Adjust prospectively for changes in estimates of cash flows
- Include independently measured and updated risk adjustment
- Adjust for time value of money using rate that reflects characteristics of liability
- Expected value considering all relevant information
- Includes all costs directly attributable to contract activity (see Note 6)

The following significant areas are to be concluded on by the IASB:
- Unbundling of non-insurance components
- Residual margin
- Use of Other Comprehensive Income (OCI) on the balance sheet
- Definition of the level of measurement (unit of account)
- Transition provisions
- Presentation and disclosures

At a glance … Insurance standard – Key changes since the July 2010 Exposure Draft (ED)
The key changes since the IASB Exposure Draft (ED) published in July 2010 are:
- Definition and scope - No significant change from ED except financial guarantee contracts (see subsequent section)
- Unbundling – some changes from ED. On-going discussions (see Note 6 and subsequent section)
- Which cash flows, including acquisition costs – some changes:
  - Recognition point (see Note 6 and subsequent section)
  - Contract boundary (see Note 6)
  - Acquisition costs (see Note 6 and subsequent section)
- Discount rate – some changes in application. No change in principle (see Note 6)
- Risk adjustment – on-going discussions: some changes from ED (see subsequent section)
- Residual margin – on-going discussions: unlocking is a significant change from ED (see subsequent section)
- Participating features – on-going discussions: some changes from ED (see Note 6)
• Short duration contracts – some changes from ED: simplified approach is permitted as a proxy to full measurement model (see subsequent section)
• Reinsurance – on-going discussions: some changes from ED in response to comment letters (see Note 6)
• Presentation – on-going discussions: some changes from ED in response to comment letters (see subsequent section)

Highlights from the IASB and FASB discussions in February 2012
• The IASB has extended the timeline for either re-exposing or issuing a staff draft on the insurance project to second half of 2012. The FASB also aims for exposure draft in the second half of 2012.
• The IASB and FASB have decided on different eligibility criteria for the premium-allocation approach; these criteria are quite similar in practice. A practical expedient has been provided for the use of the premium-allocation approach for contracts with coverage period of one year or less.
• The IASB has permitted rather than required premium-allocation approach. The FASB requires this approach if the eligibility criteria are met.
• The time value of money is to be considered in measuring liability for remaining coverage for contracts that have a significant financing component, as defined in new revenue recognition proposals. A practical expedient is provided in certain circumstances to exclude the time value of money from this measurement.
• Measurement of acquisition costs under premium-allocation approach should be consistent with building-block approach. Immediate expensing of acquisition costs for contracts with coverage period of one year or less will be permitted.
• The IASB has scoped financial instruments with a discretionary participation feature issued by insurers into insurance standard.
• Further guidance has been added on measuring onerous contracts, estimating cash flows for catastrophe events and unbundling criteria for goods and services.

Insurance Standard – significant tentative decisions
In summary, for meetings from 31 May/1June 2011 to end December 2011:

Interaction with IFRS 9 (Financial Instruments)
The IASB is considering making selective improvements to IFRS 9 (Financial Instruments) and, in particular, the interaction between accounting for financial assets and insurance contracts, with potential re-measurement through Other Comprehensive Income (OCI). This is important in the context of the ongoing debate as to how volatility in the measurement model should be addressed in the income statement. In addition, this process will enable the IASB to consider the FASB’s classification and measurement model.

Scope of the standard
It has been tentatively decided to exclude standard fixed-fee service contracts that provide service as their primary purpose from the scope of the insurance standard. This is a key change reflecting the potential impact the standard would have had on providers of products such as road side assistance and warranties.

Unbundling
It was tentatively confirmed that options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives under the financial instrument requirements should be measured within the overall insurance contract obligation using a current, market-consistent, expected value approach

Recognition of the rights and obligations in insurance contracts
It is tentatively proposed to change the position from the ED to require initial recognition at start of coverage period, or in pre-coverage period if a contract is onerous.

An insurance contract is onerous prior to start of coverage period if expected present value of future cash outflows (plus risk adjustment) exceeds:
• the expected present value of the future cash inflows from that contract (for the pre-coverage period)
• the carrying amount of the liability for the remaining coverage (for the premium allocation approach)

The onerous contract test applied when facts and circumstances indicate the contract "might" be onerous. It is expected that application guidance will be provided.
Allowance for acquisition costs
The ED required acquisition costs that are "incremental at the contract level" would be included as cash flows in initial measurement of a portfolio of insurance contracts. Effectively, introducing implicit deferral of these costs in the residual margin, rather than through a deferred acquisition cost (DAC) asset as is currently the case for most European insurers. All other acquisition costs are expensed as incurred.

The IASB has tentatively decided that all the direct acquisition costs that the insurer will incur in acquiring the contracts in the portfolio should be included in the measurement model. Direct costs would include commissions, and direct costs at portfolio level including sales force contract selling, underwriting, medical and inspection, and policy issuance and processing functions as well as direct response advertising.

It is noted that in the IASB definition there is no distinction between direct costs relating to successful and unsuccessful efforts – both types are included – while the FASB (in line with ASU 2010-26) tentatively proposes only those costs relating to successful acquisition efforts.

Inclusion of future cash flows
As considered in Note 6, it was tentatively decided that the measurement of the fulfilment cash flows should be consistent with the IFRS treatment of the assets, liabilities and other performance related items in the financial statements. This is particularly relevant for participating features. It has also been tentatively agreed that, when an insurer measures an obligation, created by an insurance contract liability, that requires payment depending wholly or partly on the performance of specified assets and liabilities of insurer that measurement should include all such payments that result from that contract, whether paid to current or future policyholders. The implications of this for participating contracts will need to be considered.

Risk adjustment
It is tentatively decided to change the risk adjustment objective from that defined in the ED to the "compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract." This is a change from the more transfer value notion in the ED. The application guidance will further clarify that:

- The risk adjustment measures the compensation that the insurer would require to make it indifferent between (1) fulfilling an insurance contract liability which would have a range of possible outcomes or (2) fulfilling a fixed liability that has the same expected present value of cash flows as the insurance contract.
- In estimating the risk adjustment, the insurer should consider both favourable and unfavourable outcomes in a way that reflects its degree of risk aversion.

In addition, the restriction to three permitted techniques (confidence level, conditional tail expectation and cost of capital) will be removed, but with the example techniques contained in the associated application guidance.

It is noted that the FSAB continues to support the single composite margin approach which combines the risk and residual margins. It is noted that the IASB and FASB will continue to explore whether the two approaches could be made comparable through disclosures.

Residual margin
The concept of the explicit residual margin – that is to avoid recognition of an accounting profit at outset – remains unchanged from the ED. The ED continued that the residual margin would be “locked in” at inception. However, this decision has been tentatively change by the IASB in a close vote, so that an insurer would adjust the residual margin prospectively, up and down to reflect favourable and unfavourable changes in future estimated cash flows, and tentatively decided not to adjust it for changes in experience or changes in risk adjustment. In addition the residual margin cannot be negative. The IASB is still discussing whether changes in the discount rate should be recognised as an adjustment to the residual margin.

Pre-claims liability for short-duration contracts:
It has been tentatively confirmed that insurers should discount the liability for incurred claims (for contracts accounted for using the premium allocation approach) when the effects of discounting would be material. In addition, it was tentatively decided to provide a practical expedient that would permit insurers not to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event, unless facts and circumstances indicate that payments will no longer occur within 12 months.
Presentation:
Several changes have been tentatively made:

- **Statement of financial position:**
  - Contracts measured using the premium-allocation approach:
    - The liability for the remaining coverage should be presented separately from the liability for incurred claims in the statement of financial position.
    - All insurance contract rights and obligations should be presented on a gross basis in the statement of financial position.
  - Contracts measured using the building block approach: any unconditional right to any premiums or other consideration should be presented in the statement of financial position as a receivable separately from the insurance contract asset or liability and accounted for in accordance with existing guidance for receivables. The remaining insurance contracts rights and obligations should be presented on a net basis in the statement of financial position.
  - Liabilities (or assets) for insurance contracts should be presented separately for those measured using the building block approach and those measured using the premium-allocation approach.
  - Portfolios that are in an asset position should not be aggregated with portfolios that are in a liability position in the statement of financial position.

- **Statement of comprehensive income:** The boards tentatively decided that an insurer should present premiums, claims, benefits, and the gross underwriting margin in this statement. The Boards will consider whether these items should be presented separately for contracts measured using the building block and the premium allocation approaches.

Disclosures:
Several changes to the disclosure requirements have been tentatively made:

- **Reconciliation of contract balances:** The Boards tentatively decided that an insurer should disaggregate certain components (i.e. expected future cashflows, risk adjustment, residual margin, effect of discounting), either in the statement of financial position or in the notes, in a way that reconciles to the amounts included in the statement of financial position.
- **Adjustments made to the disclosures covering assumptions and risks:**
  - Delete the requirement that an insurer shall not aggregate information relating to different reportable segments to avoid a conflict with the principle for the aggregation level of disclosures. Thus the level of aggregation could vary for different types of qualitative and quantitative disclosures.
  - Require separate disclosure of the effect of each change in inputs and methods, together with an explanation of the reason for the change, including the type of the contracts affected.
  - For contracts in which the cash flows do not depend on the performance of specified assets (i.e. non-participating contracts), to require disclosure of the yield curve (or range of yield curves) used.
  - Require the maturity analysis of net cash outflows resulting from recognised insurance liabilities to be based on expected maturities and remove the option to base maturity analysis on remaining contractual maturities. Furthermore, within the context of time bands, to require the insurer to disclose, at a minimum, the expected maturities on an annual basis for the first five years and in aggregate for maturities beyond five years.
  - Tentatively decided to delete the proposed requirement to disclose a measurement uncertainty analysis and to align (in due course) that disclosure with the disclosure for fair value measurements in IFRS 13 Fair Value Measurement.

**IASB staff technical papers**
The IASB has issued 4 staff technical papers on cash flows, discount rate, risk adjustment and disclosure; and has invited comments by the end of April 2012.

**Convergence between the IASB and FASB**
The IASB and FASB continue to meet to discuss the project and note that they are exploring ways to achieve convergence. For example, the IASB has listed a current task as “assess whether any differences between IASB and FASB can be reconciled.” However, there are a number of key differences which mean that convergence between the two bodies is looking increasingly unlikely in the short term.
The main differences between the IASB and FASB remain the risk adjustment / residual margin versus composite margin (including where the margins are locked in at inception); and the definition of those acquisition costs including the initial cash flows.

**Revenue Recognition Exposure Draft**
The IASB and FASB issued in November 2011 a new Exposure Draft on revenue from contracts with customers. The comment period ended on 13 March 2012. The Exposure Draft is relevant for the recognition of revenue for investment contracts (that is those contracts which do not transfer significant insurance risk). For the investment management service component of such contracts, the Exposure Draft would determine the acquisition costs and fees permitted to be deferred and the consequent amortisation of these respective asset and liability on the balance sheet. In the Exposure Draft, “incremental acquisition costs” at the contract level are permitted for deferral, compared to the current Insurance Standard tentative decision for those acquisitions costs which are directly attributable.

There are likely to be other implications which will need careful consideration.

**The Future of Financial Reporting in the UK**
On 30 January 2012, the ASB issued further proposals for a comprehensive accounting standard that will change corporate reporting for UK entities applying UK GAAP. The revised proposals replace the previous exposure drafts. Under the ASB's revised proposals an insurer currently reporting under UK GAAP will, from 2015, have a choice of applying the requirements of the new FRS, EU-adopted IFRS or, if it is a qualifying entity (subsidiaries and parents for their individual accounts), the reduced disclosure framework. The previous exposure drafts had proposed the use of IFRS for entities that have public accountability, which would have included all UK insurers. However, the reference to public accountability has been removed and the ASB now proposes that the requirement to use IFRS will continue to only apply to the consolidated financial statements of entities listed on a regulated market in the EU.

The new FRS, as drafted, indicates that IFRS 4 should be applied to insurance contracts. However, the ASB recognises that this is not necessarily the most appropriate solution and so, alongside the exposure drafts, the ASB has issued a discussion paper on insurance accounting to gather views on how insurance contracts should be accounted for under the new UK GAAP. Given the delay in the finalisation of the IASB's insurance contracts standard and the changes to regulatory accounting that will accompany the new Solvency II regulatory regime due to be implemented in 2014, there are a number of potential options for insurance contract accounting. The discussion paper sets out possible short and longer term solutions for accounting for insurance contracts in the UK.

The proposals are intended to apply for accounting periods beginning on or after 1 January 2015, with early adoption permitted.

It is noted that many UK unlisted life and general insurance companies currently apply UK GAAP even when they are within groups reporting on a consolidated basis under IFRS. In addition, unlisted insurance groups may also currently report under UK GAAP.

The discussion paper sets out a preferred long term solution of the IASB’s insurance contracts standard. However, there remains an accounting gap in the short term until that standard is finalised and endorsed for use in the EU. The ASB have put forward four possible solutions for UK insurance accounting in the gap period as follows:

- **Option 1:** Incorporate the current version of IFRS 4 into UK GAAP
- **Option 2:** Embed the relevant rules of FSA’s Realistic Capital regime into UK GAAP
- **Option 3:** Update FRS 27 and the ABI SORP for Solvency II requirements
- **Option 4:** Incorporate ‘IFRS 4 Phase II’ into UK GAAP

The ASB comment period is to 30 April 2012.