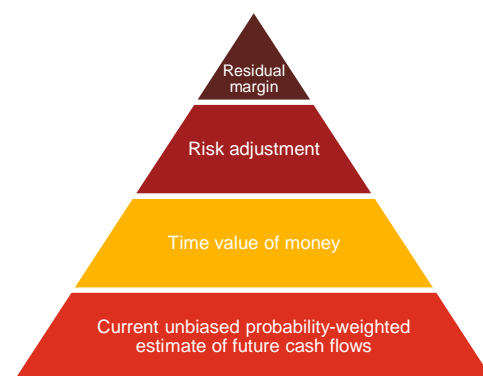


Reflecting on progress towards a comprehensive IFRS for insurance contracts

What is the issue?

Over the past seven months, the IASB and FASB have been actively deliberating the insurance contracts project in an attempt to bring the long-running insurance contract project to a close. They have considered comments received on the IASB exposure draft (ED) and the FASB Discussion Paper (DP) as well as input from their extensive outreach activity. The ED required all insurance contracts to be measured using a current estimate of the present value of expected cash flows to fulfil the contractual obligations. This measurement model is based on the building



blocks of discounted probability-weighted cash flows, a risk adjustment and a residual margin to eliminate any initial profit, except for certain short duration contracts. The boards have now agreed a number of amendments to the proposals in the ED as set out below.

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What are the key changes to the Exposure Draft proposals?

- The **discount rate** should reflect the characteristics of the liability but the boards have introduced more flexibility in allowing a top-down or bottom-up calculation of the rate. They will discuss further detailed disclosures to support the rates selected.
- The IASB has decided to adjust the **residual margin** prospectively for both positive and negative changes in cash flows, but not for changes in the risk adjustment.
- Whilst still being discussed, the IASB will require the measurement of **participating contracts** based on the measurement of underlying items that the policyholder participates in, although the FASB would use the expected present value of future cash flows.
- **Acquisition costs** included in the building block will be direct costs incremental at the portfolio level rather than at the contract level.
- The **contract boundary** wording has been amended to exclude contracts where the insurer can reassess and re-price at the portfolio level. This will enable some health insurance contracts to qualify as short duration contracts.
- Contracts will be **recognised** when coverage begins with an onerous test for the pre-coverage period, rather than when the parties agree to the contract.
- The IASB has decided to continue with the existing scope to allow **financial guarantee contracts** to be accounted for either as insurance contracts under IFRS 4 or financial instruments under IAS 39/IFRS 9. The FASB has yet to conclude whether these will be in the scope of financial instruments.
- Contracts will be required to be **unbundled** for embedded derivatives that are not closely related. Explicit account balances and other goods and services will be unbundled using guidance being developed in the revenue recognition project.
- Cedants will no longer recognise a day 1 gain on entering into a **reinsurance contract** but it will be recognised over the term of the contract. A cedant should apply the financial instruments impairment model when assessing recoverability of the reinsurance asset.

What are the key differences between IASB and FASB proposals?

It should be noted that there are a number of other differences between the IASB and FASB proposals:

- The IASB has confirmed its support for an explicit risk adjustment, whereas the FASB would have a single composite margin and is considering further the amortisation pattern for this margin.
- The IASB would include all direct acquisition costs at the portfolio level in the measurement model, whereas the FASB would exclude those relating to unsuccessful sales.
- The FASB would not unlock the composite margin for changes in cash flows.

What aspects of the proposals have the boards not yet re-deliberated or decided?

Whilst the boards have discussed the majority of the ED proposals, they have still to conclude on the following topics:

- Calculation of risk adjustment including the level of measurement (unit of account)
- Premium allocation approach for short duration contracts
- Presentation including the use of other comprehensive income
- Investment contracts with discretionary participating features
- Calculation of residual margin on transition
- Certain aspects surrounding reinsurance contracts
- Disclosures

Many companies will be interested in the final outcome of these discussions as they will affect how management will be able to use the new accounting requirements to explain the underlying performance of their business.

When is the final standard expected and what will the effective date be?

The new standard was expected by 30 June 2011. The most recent IASB work plan now indicates that the proposals will be re-exposed or a review draft will be available some time in 2012. With the proposal to move the mandatory date of IFRS 9 to 1 January 2015, the new insurance contracts standard is now not expected to be effective before this date at the earliest.

Given the myriad of different measurement models applied to insurance contracts today, there is consensus that there is an urgent need for a globally accepted, high quality IFRS for insurance contracts. However, there are clearly differences in views between the two boards. Once the SEC decides on the direction for the adoption of IFRS and as the boards continue with their extensive outreach activity (particularly in the US), it will become clearer in the months to come which direction the boards will take.

Clearly the best outcome would be the timely resolution of differences between the two boards to achieve a converged insurance contracts standard, but not at the cost of undue delay or compromising on quality. If the boards are unable to agree on the key differences, it is possible that the IASB may decide to move ahead alone in order to provide its constituents with a global standard to apply in accounting for insurance contracts. This decision may also be influenced by the extent of convergence the boards are able to achieve in the accounting for financial assets.

What do I need to do?

Management need to continue to monitor the debate and understand where the proposals could affect their organisations. If the proposals are re-exposed, there will be a formal opportunity to comment. Understanding the size of the change on an organisation's financial statements and key performance indicators will better assist in the preparation of comment letters and lobbying positions.

In addition, if substantial changes are being made to financial reporting or actuarial modelling systems, driven for example by solvency II, companies should consider how to make these flexible enough to accommodate future changes as a result of the insurance project. Once we have further clarity on the timing and direction of the IASB, companies should fully assess the impact of the proposals on their change programmes, considering the financial, process, systems and people impact to appropriately plan for implementation.

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