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Straight away

IFRS bulletin from PricewaterhouseCoopers

IASB proposes to fundamentally change accounting for insurance contracts

What is the issue?

The IASB has issued an exposure draft of a comprehensive standard that will fundamentally change the accounting by insurers and other entities that issue contracts with insurance risk. The proposals are the output of the IASB and FASB's joint efforts to develop a single converged insurance standard. The FASB plans to issue a discussion paper that will incorporate the IASB's proposals. The proposed standard would replace IFRS 4, which currently permits a variety of practices in accounting for insurance contracts.

Scope of the proposals

The proposed standard would apply to all entities that issue contracts that contain insurance risk. The exposure draft retains the IFRS 4 definition of an insurance contract as "*a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder*". This broad definition could result in contracts issued by non-insurers being subject to the standard, such as certain financial guarantee contracts and loans with waivers upon death. However, unlike IFRS 4, fixed fee service contracts where the level of service depends on an uncertain future event (such as maintenance contracts where specified equipment is repaired after a malfunction) will not be within the scope of the proposed standard. The standard does not address the accounting by policyholders (other than reinsurance) entering into insurance contracts.

Insurance contracts often contain other elements such as financial or service components. These are required to be unbundled and accounted for separately if they are not closely related to the insurance coverage. In particular, embedded derivatives will be separated in accordance with IAS 39 and certain account balances will be required to be unbundled.

Measurement model

The proposals require that all insurance contracts will use a current measurement model of the present value of expected cash flows to fulfil the obligation, where estimates are re-measured at each reporting period. Except for certain short duration contracts, 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.

The cash flows are explicit, unbiased, probability-weighted cash flows that the insurer expects to incur in fulfilling the contract including expected premiums, policyholder benefits, expenses and participating dividends. Unlike the previous discussion paper proposal, the cash flows are measured from the issuer's perspective (rather than a market participant) although any market variables must be consistent with observable market prices. Acquisition costs that are incremental to a contract (such as commissions) will be included in these net cash flows rather than deferred as an explicit asset, but all other acquisition costs will be expensed when incurred.

The estimated cash flows are discounted at risk free interest rates adjusted for differences between the liquidity characteristic of the insurance contracts and the corresponding risk free instruments. The discount rates will not be based on the assets backing the insurance contracts, unless those asset returns affect cash flows to the policyholders.

The measurement model includes an explicit risk adjustment for the effects of uncertainty about the timing and amount of future cash flows. This adjustment is the maximum amount the issuer would pay to be relieved of the risk that the ultimate cash flows exceed those expected. The inclusion of an explicit risk adjustment has been one of the most controversial issues in the boards' discussions. The exposure draft limits the permitted techniques to calculate this

adjustment. The residual margin eliminates any initial gain on the contract. It is not subsequently re-measured but is released in a systematic way over the coverage period. Any initial loss on a contract is recognised immediately in profit or loss.

As a result of the debates around the risk adjustment, the exposure draft outlines an alternative measurement model favoured by the FASB, that also eliminates any initial profit but has a single composite margin, rather than recognising an explicit risk adjustment and a residual margin.

The proposals require that short duration contracts of approximately 12 months or less that do not contain any embedded derivatives or options are initially measured as premiums less any incremental acquisition costs. This pre-claim liability is reduced in a systematic way over the coverage period with any claims that occur being measured using the building block approach described above.

At each balance sheet date the discounted estimated future cash flows and risk adjustment are updated based on current estimates. Any changes (both positive and negative) in either financial variables (such as the discount rate) or other estimates (such as expenses, claims experience, lapses and the risk adjustment) are recognised immediately in profit or loss.

Income statement presentation
Under the proposals the income statement will be driven by the measurement model. Issuers will not recognise premiums as revenue (except where the short duration simplified approach is used) but will separately show an underwriting margin (comprising changes in the risk adjustment and residual margin) and changes in estimates and experience variances. Supplemental disclosures would provide premium and claim information.

Transition arrangements
The exposure draft includes transition provisions that require insurance contracts in force at the transition date to be measured at the present value of the expected cash flows and risk adjustment as described above without any residual margin (after writing off any deferred acquisition costs). This means that the only profit that will be recognised in future profit or loss for contracts in existence at transition will come from the release of the risk margin, experience variances and any subsequent changes in estimates. This is likely to be a significant change for most life insurers.

Am I affected?

The proposals will affect all entities that issue contracts that meet the definition of insurance contracts, including financial guarantee contracts. The proposals are likely to result in increased volatility in the income statement and significant changes in the presentation of the income statement. The proposals will create additional demands on data and modelling systems. The extent of these demands will vary from territory to territory, depending on current accounting and regulatory reporting requirements

What do I need to do?

Given the profound impact of the proposed changes, management should begin to assess the implications of the new model on their existing contracts and current business practices. Management should also consider commenting on the exposure draft to ensure their views on the significant changes are considered. The comment letter period ends on 30 November 2010 and a final standard is currently expected in mid-2011.

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