

2010–39

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Insurance Contracts Fundamental Accounting Changes Proposed

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Overview

At a glance

- The FASB has issued a discussion paper seeking comments on its preliminary views on accounting for insurance contracts that would fundamentally change the accounting by insurers and other entities that issue contracts with insurance risk.
- The discussion paper is an outgrowth of the IASB and FASB's joint efforts to develop a single converged insurance standard. The FASB's release of the discussion paper follows the IASB's late July issuance of an exposure draft containing its proposals on the same topic. Both documents address recognition, measurement, presentation, and disclosure for insurance contracts.
- The discussion paper compares the IASB's proposal to the FASB's preliminary views to date and to current US GAAP. The FASB is asking constituents to consider whether the FASB should ultimately adopt some version of the IASB's proposal or whether targeted changes to existing US GAAP would be sufficient.
- There is greater urgency for the IASB to adopt some version of its exposure draft as a final standard since comprehensive guidance on insurance accounting does not currently exist under IFRS; a final IASB standard is expected in mid-2011.
- Given the potential impact of the changes being considered, management should consider assessing the implications of the possible changes on existing contracts and its current business practices and commenting on both documents.
- The comment letter period on the FASB discussion paper ends on December 15, 2010 (or November 30, 2010 for roundtable participants). The comment period for the IASB's exposure draft ends on November 30, 2010.

The main details

.1 The FASB issued a discussion paper, *Preliminary Views on Insurance Contracts*, on September 17, 2010 as part of the IASB and FASB's joint efforts to develop a single converged insurance standard. This followed the IASB's issuance of an exposure draft, *Insurance Contracts*, on July 30, 2010. The main details are as follows.

- Both the IASB exposure draft and FASB preliminary views (the "proposals") would apply to all entities that issue insurance contracts, not just insurers. The boards would utilize a broad definition of insurance contracts that could result in contracts issued by non-insurers being subject to the guidance, such as certain financial guarantee contracts, loans with waivers upon death, certain types of warranty contracts, and, under the FASB proposal, health insurance provided by employers.

- The accounting by policyholders (other than reinsurance) entering into insurance contracts is not addressed.
- Both proposals would require an insurer to measure its insurance contracts using a current measurement model, where estimates of the present value of cash flows are re-measured each reporting period. The estimated cash flows would be discounted at risk-free interest rates, adjusted for differences between the liquidity characteristic of the insurance contracts and corresponding risk-free instruments.
- The IASB approach would include an explicit risk adjustment for the uncertainty about the amount and timing of future cash flows that would be separately estimated and remeasured each period. The FASB approach would not.
- At contract inception, both proposals would defer and amortize any excess of expected cash inflows over outflows to eliminate any initial profit, but would recognize any losses immediately. This amount is referred to as the composite margin under the FASB approach and as the residual margin under the IASB approach.
- Cash flows under both proposals would be measured from the issuer's perspective (rather than a market participant perspective), although any market-related variables would be consistent with observable market prices.
- Incremental contract acquisition costs (such as commissions) would be included in the net cash flows, effectively deferring and amortizing them over future periods, although not as an explicit asset. All other acquisition costs would be expensed as incurred.
- Under both proposals, account balance, embedded derivative, and certain service components would be required to be unbundled and accounted for separately if they are not closely related to the insurance coverage.
- The IASB's proposal requires short duration contracts of approximately 12 months or less to be measured using a simplified approach. The FASB has not settled on a view on this matter.
- Under both proposals, the income statement presentation would be driven by the measurement model. Issuers would not recognize premiums as revenue (except where the short duration simplified approach is used) but would separately show an underwriting margin and changes in cash flow estimates and experience variances. Supplemental disclosures would provide premium and claim information.
- The IASB expects to issue a final standard in mid-2011. An effective date has not been proposed yet, although it is expected that the IASB standard would not be effective before 2013. The FASB's next step, after gathering comments from constituents on the discussion paper and at the public roundtables planned with the IASB in December, will be to determine whether its exposure draft of a proposed standard should use some version of the model described in its discussion paper or instead make targeted changes to existing US GAAP.

PwC Observation: The FASB's decision to issue a discussion paper reflects the fact that it has had less time to debate the issues. US GAAP also currently has specific accounting guidance for insurance contracts and so the need to address the accounting for insurance contracts is not as urgent as for IFRS preparers. A key difference between

the FASB and IASB approaches is the IASB's preference to include a specific risk adjustment on a current measurement basis and a residual margin compared to the FASB's preference for a single "locked in" composite margin.

Key provisions

Definition and scope

.2 Both the FASB and IASB proposals would apply to all entities that issue insurance contracts, not just insurers. Both approaches utilize the IFRS 4 definition of an insurance contract, i.e., "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."

.3 As in IFRS 4, insurance risk is defined as any risk other than financial risk where financial risk is "the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract".

PwC Observation: Some banks issue loans that include a waiver of the outstanding loan balance upon the death or disability of the customer. These contracts are likely to meet the definition of an insurance contract, but the extent to which they would be affected by the proposals will depend on the unbundling rules, as discussed later in this DataLine. Financial guarantee insurance, mortgage guarantee insurance, trade credit insurance, and some letters of credit often issued by banks would be within the scope of the proposals. However, contracts that pay out regardless of whether the counterparty holds the underlying debt instrument or on a change of credit rating or credit index would continue to be accounted for as financial instruments. The scope of the discussion paper is generally consistent with existing US GAAP as it relates to insurers, but may result in changes in banks' accounting for certain types of instruments.

.4 The proposals would exclude from the scope of the guidance certain contracts that meet the definition of insurance contracts. The exemptions carried forward from IFRS 4 include:

- Product warranties issued by a manufacturer, dealer or retailer
- Residual value guarantees provided by a manufacturer, dealer or retailer as well as a lessee's residual value guarantee embedded in a finance lease
- Contingent consideration payable in a business combination
- Employers' assets and liabilities under certain employee benefit plans
- Insurance contracts that an entity holds as a policyholder (although a cedant will apply the proposals to reinsurance contracts that it holds)

.5 The boards' approaches would exclude fixed fee service contracts that expose the service provider to risk because the level of service depends on an uncertain event (such as maintenance contracts where specified equipment is repaired after a malfunction). However, the proposals note that an insurer should apply the proposals to insurance contracts in which the insurer provides goods and services to the policyholder to compensate the policyholder for insured events.

PwC Observation: The boards intended for fixed fee service contracts (such as roadside assistance contracts and repair services) to be outside of the scope of the proposals. However, the wording in the scope paragraphs includes contracts where the insurer provides goods or services to compensate the policyholder for insured events, which seem to include such contracts given the definitions within the proposals. Some contracts are not specifically mentioned in the guidance, and thus it is unclear whether they would be covered by the approaches under consideration.

Although medical coverage was not addressed in much detail during the FASB and IASB deliberations, the IASB ED references "insurance against medical costs" as being within the scope of its proposed guidance. This includes payments to be made in kind in which the insurer provides goods or services to the policyholder to settle the obligation. An example given in the proposed IASB application guidance is when an insurer uses its own hospitals and medical staff to provide medical services covered by the contracts.

In addition, while the IASB proposes to exclude from the scope all employer assets and liabilities under employee benefit plans, including health insurance plans, the FASB has not reached a preliminary view as to whether employer provided health insurance should be excluded. If employer provided health coverage is included in the scope, this could greatly expand the number of non-insurance companies that would need to implement the FASB proposal, as many companies directly offer health benefits to employees. In contrast, in those situations where the employer is merely providing employees access to a third party health insurer and not taking on insurance risk, the employer would not be subject to the proposal.

.6 The scope of the IASB ED includes financial instruments containing discretionary participating features, while the FASB preliminary view is that such contracts are financial instruments that should be excluded from the scope of insurance contract accounting. These are considered further in the section on discretionary participating features below.

.7 Within the definition of an insurance contract is the requirement that there be an uncertain future event. IFRS 4 (and the FASB's and IASB's proposals) requires that at least one of the following be uncertain at the inception of an insurance contract:

- Whether an insured event will occur
- When the insured event will occur (timing risk)
- How much the insurer will need to pay if the insured event occurs (underwriting risk)

.8 While US GAAP for reinsurance transactions (and, by analogy, for insurance transactions) requires both underwriting and timing risk, IFRS 4 and the proposals require only one or the other. However, the proposals would amend IFRS 4 guidance slightly to note that certain timing delays might be so significant so as to disqualify a contract from risk transfer because the delays could eliminate or significantly reduce uncertainty of cash flows.

.9 The proposed guidance, taken from IFRS 4, notes that insurance risk is significant if an insured event could cause an insurer to pay significant additional benefits in any scenario, as compared to the benefits that would be payable if the insured event did not occur. The focus in IFRS 4 is on whether there is variability in the amount of claim/benefit payments that could be paid whereas US GAAP focuses on the significance of the potential claim benefit payments in relation to the premium received.

PwC Observation: FASB members and some IASB members were uncomfortable with the application of insurance accounting for contracts that had no chance of loss to the insurer. As a result, late changes to the proposals borrow from US GAAP by noting that a

contract would not transfer significant insurance risk if there is not a scenario that has commercial substance in which the present value of net cash outflows can exceed the present value of the premiums. Given this revised guidance, it is unclear whether certain contracts that guarantee a return of premium would meet the definition of an insurance contract.

.10 The significant insurance test is required to take into consideration the time value of money. In addition, unlike existing US GAAP, the risk transfer test can be met "even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the contractual cash flows from the insurance contract."

PwC Observation: The proposed guidance differs somewhat from existing US GAAP, which requires the presence of both timing and underwriting risk, no timing delays, and a risk transfer test (at least for reinsurance) that focuses on "the reasonable possibility of significant loss" as measured by a comparison of contractual cash flows to contractual premium.

Measurement model

.11 Both the FASB and IASB proposals would require a single measurement model for all insurance contracts that portrays a current assessment of the amount and timing of the future cash flows that the insurer expects its existing insurance contracts to generate as it fulfills its rights and obligations under the contract. This measure consists of the following "building blocks:"

- An explicit, unbiased and probability weighted estimate (i.e., expected value) of future cash outflows less future cash inflows
- A discount rate applied to those cash flows to reflect the time value of money

The IASB approach would also include a third "building block," an explicit risk adjustment to reflect the estimate of the effects of uncertainty about the amount and timing of those future cash flows, while the FASB proposal would not.

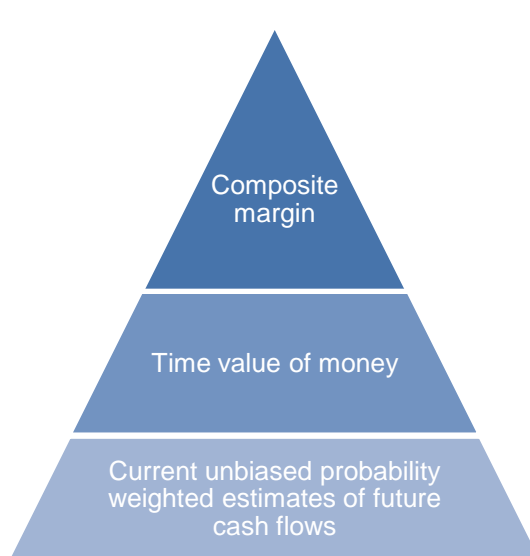


Figure 1: FASB Measurement model

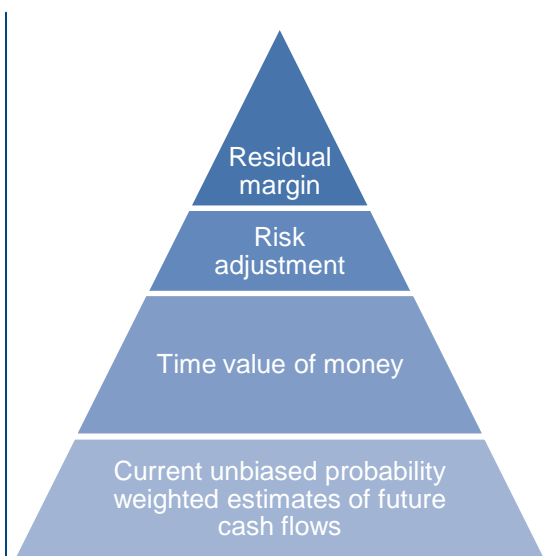


Figure 2: IASB Measurement model

.12 The boards believe that there should be no "day one" profit recognition for insurance contracts, which would be consistent with the proposals in the revenue recognition project. As a result, if the present value of cash flows (plus the risk adjustment in the IASB model) gives rise to an asset, a composite margin (or residual margin in the IASB model) is added to eliminate any day one gain and therefore the contract is measured initially at nil. If the present value of the cash flows (plus the risk adjustment in the IASB model) is greater than zero, the insurer recognizes that present value as a loss, as it represents a loss on an onerous contract. Subsequent changes in the present value of cash flows (and the risk adjustment in the IASB model) could create an insurance asset or liability.

PwC Observation: In the FASB model, a loss on day one would be recognized when expected cash outflows are greater than the expected cash inflows. In the IASB model, a loss may be recognized in situations where in the FASB model it would not because the FASB model does not include an explicit risk adjustment in the measurement of expected cash flows.

.13 Both the FASB and the IASB propose that an insurer treat insurance contracts in a foreign currency as monetary items when applying foreign currency transaction guidance. In the FASB model, the requirement applies to all insurance contract cash flows and the composite margin. Similarly, in the IASB model, the requirement applies to all insurance contract cash flows, the risk adjustment, and the residual margin.

PwC Observation: This will eliminate the accounting mismatches that arise under US GAAP and IFRS 4 when unearned premiums and deferred acquisition costs are treated as non-monetary items by property and casualty insurers.

Cash flows

.14 The cash flows included in both the FASB and IASB versions of the measurement model are an explicit, unbiased, and probability weighted estimate of the incremental future cash outflows less future cash inflows that will arise as the insurer fulfills the insurance contract. This expected value is determined by considering the range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for the particular outcome and the estimated probability of that outcome. The cash flows from each outcome are discounted and weighted by the probability factor to drive the expected present value. Unlike many current accounting models, which develop a single "best estimate," all probabilities (even remote ones) are considered and weighted. The application guidance notes that not all cases will require the development of explicit scenarios. However, in cases where there are complex underlying factors that behave in a non-linear fashion, sophisticated stochastic modeling may be needed.

PwC Observation: The expected value is based on an evaluation of all possible outcomes, considering the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The use of probability-weighted cash flows, while increasingly common in more recent accounting standards, is not an explicit element of current estimates of life and non-life insurance liabilities in the US. The objective of this approach is to incorporate variability in the estimate of cash flows by identifying all possible scenarios and making unbiased estimates of the probability of each scenario. Such an approach results in a statistical mean, rather than a "best estimate" or "most likely" outcome. Some believe that the "actuarial central estimate" commonly used by property and casualty actuaries in their development of estimates of unpaid losses is consistent with the proposed approach. Whether the objective of the new measure can be achieved with existing methodologies and systems or whether major changes will be required to both remains to be seen.

.15 The cash flows should include all incremental cash inflows and outflows arising from a portfolio of insurance contracts. A portfolio is defined as insurance contracts that are subject to broadly similar risks and managed together as a single pool. Cash outflows will include direct costs and systematic allocations of costs that relate directly to the contract or contract activities. These cash flows will include policy administration and maintenance costs but will exclude general overhead and income tax payments and receipts, which are recognized and measured under income tax accounting guidance. Cash flows should be current and reflect the perspective of the insurer, except for market variables, which should be consistent with observable market prices. The application guidance notes that the use of a portfolio of replicating assets (a replicating asset is one whose cash flows exactly match the contract cash flows) would be an appropriate way of incorporating market variables.

.16 Cash flows to be included in the building block measurement will include only those cash flows generated as the insurer fulfills the existing contract. Many contracts contain features such as extension or termination features or re-underwriting options, which make it difficult to determine the length of the contract. Thus, it is necessary to draw a contract boundary for these cash flows. The proposals would require that estimated cash flows be included to the point at which an insurer either is no longer required to provide coverage or has the right or the practical ability to reassess the risk of the particular policyholder and can set a price that fully reflects that risk.

PwC Observation: The definition of the contract boundary could have an impact on certain health insurance and other contracts where a regulator imposes constraints on re-pricing for individual policyholders. In some territories these contracts are currently treated as short-duration contracts, but under the proposals the expected cash flows may extend beyond the one year boundary if the insurer cannot fully re-price and re-underwrite the individual policy. The FASB is seeking input from constituents on the implications of the recent US healthcare reform provisions on the definition of the contract boundary. Alternatively, there may be contracts that are currently treated as long term in some territories where the proposals for the contract boundary will result in only cash flows for a shorter period being taken into account (for example if the contracts can be re-priced for a change in risk). If these contracts have significant acquisition costs that are recovered from cash flows in later periods beyond the contract boundary, this could lead to an initial loss being recognized.

.17 Insurance contracts often include embedded options and guarantees, such as guarantees of minimum investment returns, maximum charges for mortality, surrender options, or options for the policyholder to reduce or extend coverage. The proposed measurement model requires the expected cash flows to reflect expected policyholder behavior, including features that allow policyholders to take actions to change the amount, timing or nature of the benefits they will receive.

PwC Observation: In some countries insurers issue policy loans to customers secured against the insurance contracts. Insurers would need to consider whether these loans represent cash flows under the insurance contract or are separate financial instruments that would be accounted for under financial instruments accounting.

Discount rate

.18 The discount rates applied in the building block model should be consistent with observable current market prices for instruments with cash flows whose characteristics match those of the insurance liability in terms of timing, currency, and liquidity. Those characteristics are not reflected by using discount rates based on expected returns on actual assets backing those liabilities. For contracts where the cash flows do not depend on the performance of specific assets, the discount rates should reflect the yield curve for

instruments that are essentially risk free with an appropriate adjustment for illiquidity. For contracts where the cash flows do depend wholly or partly on the performance of specific assets, the measurement of the insurance contracts should reflect that dependence. The present value of the fulfillment cash flows should not reflect the risk of non-performance of the insurer.

PwC Observation: The recent credit crisis highlighted the difficulty in distinguishing between illiquidity and credit risk within market prices. In valuing insurance liabilities, there will be contracts that are clearly liquid due to policyholder surrender options and other contracts, for example, annuities, where the cash flows are predetermined and not flexible and hence illiquid. The challenge will be to determine when it is appropriate to apply an adjustment for illiquidity for contracts that fall in between these two extremes. There also will be complexities in the use of an interest rate curve instead of a single discount rate. In some situations, multiple curves may be required for contracts with different benefits, some of which are based on investment returns and others that are not. By using current rates, investment asset and liability mismatches, such as duration and credit characteristics, will be measured in the financial statements at current assumptions as opposed to long-term assumptions used in many models today.

The boards are asking for specific comments on whether the fulfillment cash flows should reflect the non-performance risk of the insurer. In responding to this proposal insurers will need to consider the impact of financial instruments accounting on the measurement of financial assets backing the insurance contracts. In particular, will accounting mismatches arise if changes in the fair value of financial assets due to changes in the market price of credit risk are reflected in the income statement but the measurement of the liability excludes some of this market movement if it is attributed to the risk of non-performance by the insurer?

Risk adjustment

.19 One of the most controversial issues in this project is whether, in addition to the probability weighted cash flows, an additional amount (referred to as an "explicit risk adjustment"), should be included in measuring the contract liability to reflect the effects of uncertainty inherent in the estimated future cash flows. After much deliberation, the IASB decided that an explicit risk adjustment should be part of the building block measurement while the FASB decided that it should not.

.20 The IASB proposal therefore includes an explicit risk adjustment for the effects of uncertainty about the amount and timing of future cash flows from the perspective of the insurer rather than from the perspective of a market participant. The risk adjustment is the maximum amount the insurer would rationally be willing to pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected. The risk adjustment is required to be included in the building block model in an explicit way, separate from the estimates of discounted future cash flows and separately disclosed. The IASB application guidance notes that care will be needed to ensure that risks are not duplicated. For example, if cash flows are measured using a replicating portfolio or other market observable inputs, then the measurement will already include the associated risk adjustment for these cash flows.

.21 In order to address concerns over comparability and reliability, the IASB guidance limits the range of permitted techniques for calculating the risk adjustment to the "confidence-level" technique (value at risk), the "conditional tail expectation" technique (tail value at risk), or the "cost of capital" technique. Some application guidance on each of these approaches is given, including in what circumstances each technique might be appropriate. In addition, entities will be required to disclose the confidence level to which the risk adjustment corresponds, even if a cost of capital or conditional tail expectation technique has been used.

.22 The IASB proposal requires the risk adjustment to be measured at a portfolio level. The adjustment will therefore allow for risk diversification within that portfolio but not between different portfolios within a group.

PwC Observation: The cost of capital technique may differ from that used to price the contract or used for solvency purposes. The benefits of the explicit risk adjustment is that it reflects an explicit amount for risk included in the liability at each reporting period, reflects subsequent changes in risk, and ensures that an insurance liability includes a margin. An explicit risk adjustment is consistent with the pricing of financial instruments and written options as well as the proposals in the IAS 37 exposure draft on liabilities of uncertain timing or amount. It also reduces the amount of the residual margin that is amortized. The challenge for insurers to reliably and consistently measure the risk adjustment will vary from territory to territory depending on whether similar risk adjustment techniques are used for capital management or solvency requirements. The emergence of profit under each of the techniques will vary, as well as the drivers influencing the risk adjustment, for example, the price of capital will affect the cost of capital technique.

Composite margin (FASB approach)

.23 A majority of the FASB rejected the inclusion of an explicit risk adjustment and instead decided on a composite margin approach. Under the composite margin approach, any positive difference between the present value of expected cash inflows and outflows calculated under the building block approach is recorded as the initial composite margin amount and amortized over the coverage and claim settlement period. Any negative amount is immediately expensed. The composite margin is presented as part of the insurance contract liability.

PwC Observation: The inclusion of an explicit risk adjustment in the insurance liability estimate is an unfamiliar concept in non-fair value measurements of insurance liabilities (or similar types of uncertain liabilities) in the US today. While some see the need for an explicit margin to reflect the level of uncertainty inherent in a particular set of cash flows, many are concerned that estimating an explicit risk margin may reduce the reliability and comparability of the measure, while adding additional complexity and subjectivity to what is already a subjective estimate. In contrast, European companies will use a cost of capital approach in the regulatory construct of Solvency II to calibrate risk margins, and Australian property and casualty companies have had some experience with estimating risk margins for financial reporting purposes.

Opponents of an explicit risk adjustment, which includes a majority of the FASB, have expressed concerns with the appropriateness of an explicit risk adjustment in a non-fair value measure and with the reliability and consistency of calculation methodologies for this risk adjustment. In addition, they note that there is no single technique for calculating the adjustment that is universally accepted and used, resulting in a potential comparability issue across insurers. Opponents note that even if a particular method is used, there is still much subjectivity in selecting the parameters of measurement, such as the appropriate confidence level. In addition, unlike other estimates, such as claims estimates, it is not possible to perform direct tests to assess retrospectively whether a particular risk adjustment is reasonable.

Subsequent measurement and the residual margin (IASB approach) or composite margin (FASB approach)

.24 Under the IASB approach, at the end of each reporting period, the insurance liability would be measured as the sum of the present value of fulfillment cash flows, including the risk adjustment, and the remaining residual margin. Therefore, at each reporting period, the liability will reflect current estimates of cash flows, current discount rates, and a risk

adjustment that reflects the remaining risk of uncertainty about the amount and timing of those cash flows. Any changes in the estimates are recognized immediately in the income statement.

PwC Observation: Recognizing changes in estimates in the income statement will lead to an increase in volatility of reported results for many insurers that currently use fixed assumptions. Under the IASB proposal, changes in estimates would not be recognized in other comprehensive income (OCI). Some argue that this could result in accounting mismatches where assets are measured on an amortized cost basis and equities are measured at fair value through OCI. Another criticism of the proposals is that a gain on initial recognition would not be permitted to be recognized in the income statement, yet if there is a positive change in the estimates of cash flows on day two, it would be recognized immediately in the income statement.

.25 The residual margin is calibrated at inception to an amount that avoids a gain being recognized when an insurer enters into the insurance contract. The residual margin is determined within a portfolio by date of inception and by length of the contract. The residual margin is recognized over the coverage period in a systematic way that reflects the exposure from providing insurance coverage. This is on the basis of time or, if claims are expected to be incurred in a different pattern, on the basis of the timing of expected claims.

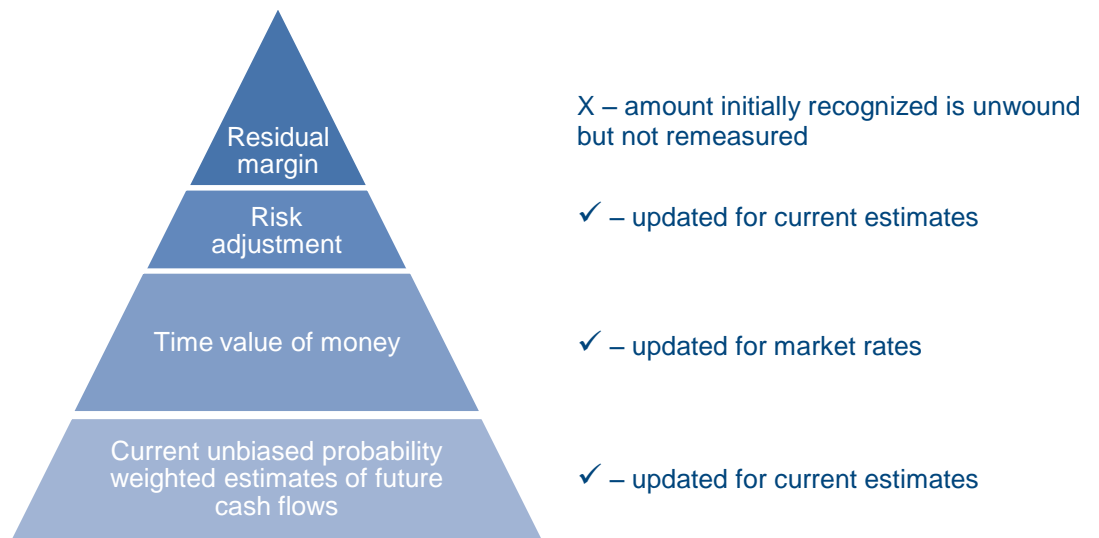


Figure 3: Subsequent measurement – IASB Approach

PwC Observation: It is not clear in the proposal whether the pattern of amortization of the residual margin in the income statement can change. For example, it is unclear whether the residual margin can be released if the occurrence of a claim means that the risk of any further claim is reduced or eliminated.

.26 The residual margin is not adjusted when there are changes in estimates of both financial variables (such as discount rates and equity prices) and other estimates (such as expenses and lapses) unless a contract terminates. The residual margin accretes interest at the discount rate used at inception.

PwC Observation: The IASB did not consider an alternative method for the subsequent measurement of the residual margin by recalibrating the residual at each reporting date considering all current information. Under this alternative, the residual margin could be restated at inception of the contract using updated experience (up to the reporting date) and assumptions of future cash flows. This would lead to part of the change in estimates being recognized immediately in the income statement and the remainder adjusting the unamortized portion of the residual margin and recognized over the remaining coverage period. However, such an approach would be complex to model for long term contracts.

.27 The FASB’s alternative model would have a single composite margin on inception of the contract. Under this approach the insurance liability at each reporting date would be the sum of the present value of probability-weighted cash flows (with no risk adjustment) and the remaining composite margin. The composite margin would be amortized over both the coverage and claims handling period according to the following formula:

$$\frac{\text{Premium allocated to date} + \text{Claims and benefits paid to date}}{\text{Total expected contract premiums} + \text{Total expected claims and benefits}}$$

All of the amounts in the above formula would be undiscounted. Although the composite margin amount calculated at inception would not be re-measured to reflect any changes in risk and uncertainty, the amounts used in the formula above would be re-measured based on current estimates at each period end. As a result of this retrospective catch-up type of approach, the amortization pattern for the composite margin would be altered as changes in estimates in the ratio occur. Interest would not be accreted on the composite margin.

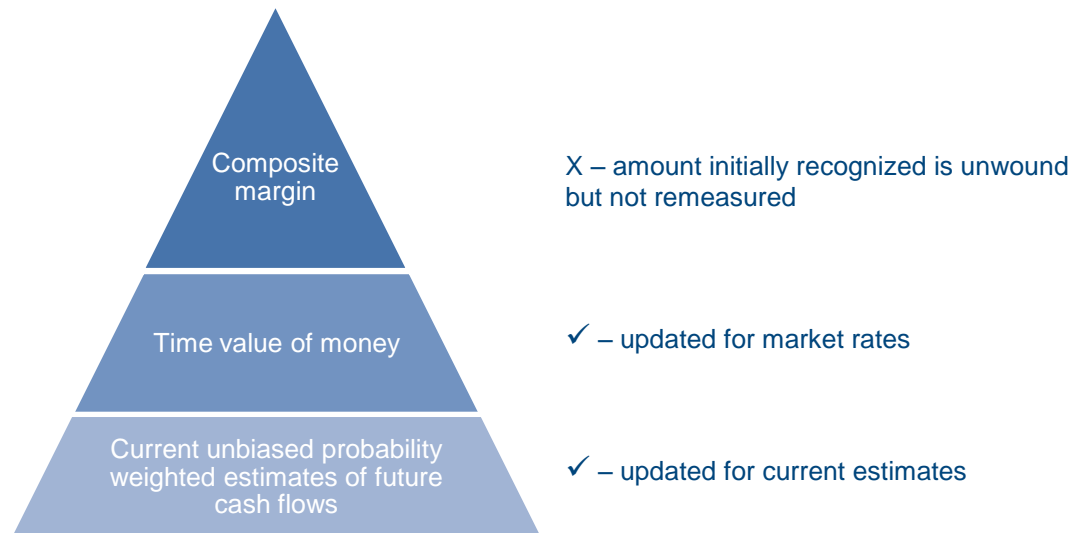


Figure 4: Subsequent measurement – FASB Approach

PwC Observation: Supporters of the composite margin approach argue that this approach avoids the concern that a risk adjustment is inconsistent with the fulfillment objective of the proposal. The advantage of the approach is that it avoids the concern over comparability and consistency of different ways of calculating and calibrating a risk adjustment. It is also likely to be easier and less costly to implement.

Acquisition costs

.28 Under both the FASB and IASB proposals, acquisition costs that arise from and are incremental to an individual contract are included in the present value of fulfillment cash flows. These are defined as “the costs of selling, underwriting, and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular insurance contract.” The inclusion of these costs in the fulfillment cash flows will reduce the composite margin (under the FASB approach) and the residual margin (under the IASB approach) on initial recognition of the contract. All other acquisition costs are expensed when they are incurred.

PwC Observation: The restriction to incremental acquisition costs is consistent with the treatment of transaction costs in IFRS on financial instruments (IAS 39). However, it is more restrictive than current accounting in many territories, which may allow an element of allocated direct costs or overhead to be treated as deferred acquisition costs. Even under the newly revised definition of acquisition costs under US GAAP, both incremental costs as well as certain direct costs of acquisition, such as the portion of internal salaried sales force, underwriting, and policy issue costs relating to successful contract sales, are capitalizable.

The proposals would mean that the distribution model may affect reported profits. Insurers that use independent intermediaries (or pay their internal sales force on a commission basis) are likely to incur a commission, which is usually incremental at the contract level and so will be a fulfillment cash flow in the building block approach. This treatment will result in the reduction of the recognized composite margin (FASB) or residual margin (IASB) on day one. When the commission is paid, it will be treated as a contract cash flow reducing the liability with no impact on the income statement. However, insurers that perform direct marketing or have a salaried in-house sales force will likely have lower acquisition costs that are considered incremental to a specific insurance contract. Thus, they will have a larger composite margin (FASB) or residual margin (IASB) for a contract that is recognized over the coverage period and will expense most of their acquisition costs immediately, which could give rise to an initial loss.

Simplified measurement model for pre-claims liability of short-duration contracts

.29 The IASB proposal requires that for short-duration contracts of approximately one year or less that do not contain any embedded derivatives or options, the pre-claims obligation would be measured as the premium received at initial recognition plus the expected present value of future premiums that are within the boundary of the contract less the incremental acquisition costs of issuing the contract. For balance sheet purposes, this obligation will be offset by the expected present value of premiums and referred to as the pre-claims liability. Any claims that arise on these contracts would be measured at the present value of the fulfillment cash flows using the building block model (including the risk adjustment), as for all other insurance contracts.

.30 An onerous contract test (which is similar in concept to the current liability adequacy or premium deficiency test) would be required under the IASB simplified approach for the pre-claims liability. At initial recognition and subsequently, a contract is onerous if the present value of fulfillment cash flows (including the risk adjustment) exceeds the carrying amount of the pre-claims obligation. In this case the insurer would recognize an additional liability for this difference and recognize an expense in the income statement. This onerous contract test would be performed at the portfolio level of contracts with a similar date of inception.

PwC Observation: The performance of the onerous contract test for a portfolio of contracts with a similar date of inception may be at a lower level than current accounting practice would require. The definition of a portfolio may be open to different interpretations.

.31 Under the IASB proposal, the pre-claims obligation would be reduced over the coverage period in a systematic way that reflects the exposure from providing insurance coverage. Similar to the residual margin in the IASB version of the building block model, this would be amortized based on the passage of time or the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time. Interest would accrete on the pre-claims liability at the current rate.

PwC Observation: The IASB has proposed that the simplified measurement approach be used for the pre-claims liability of short-duration contracts that meet stipulated criteria. This means that property and casualty insurers may have to apply two different measurement models for similar contracts where only the contract term is different. The IASB considered whether to permit the use of the simplified approach rather than require it, given that it can be seen as a practical short cut. To enhance comparability the IASB decided to require the simplified approach if contracts meet the specified conditions.

The IASB ED is unclear about whether an insurer would be allowed/required to release any pre-claims liability in the event that the occurrence of a claim curtails any of the remaining insurance coverage. It is also not clear whether the pattern of release of the pre-claims liability can change if the expectation of claim and benefit payment patterns change.

An assuming reinsurer that commits to reinsure policies written by an insurer in the next twelve months may not meet the short-duration contract criteria if the coverage period of the underlying contracts is considered to be the coverage period for the reinsurance contract.

.32 During the joint deliberations, the FASB discussed the simplified measurement method proposed by the IASB but did not conclude on whether and when a simplified approach might be appropriate. In its discussion paper, the FASB asks constituents whether a "modified approach" might be appropriate and how the scope for such an approach should be defined. For example, should the scope be based on the duration of the coverage period, the duration of the claims payment period, the type of insurance, or current guidance?

.33 The FASB discussion paper does not address how the modified approach might be applied to claims in the context of the FASB's composite margin approach. For example, one issue to consider would be how claim liabilities would be calculated under the FASB's version of a modified approach, i.e., with or without allocation of a composite margin. Use of an earned premium approach during the coverage period, combined with the exclusion of a composite margin in the post-coverage period, would result in accelerated recognition of profit when compared to the composite margin building block approach. This would also typically result in accelerated recognition of profit compared to the current US GAAP model in which claim liabilities are not discounted.

Reinsurance

.34 Both the FASB and IASB proposals require that reinsurance business assumed be measured using the same building block measurement approach as for other insurance contracts. Ceding commission paid to the ceding company would be treated as a reduction in premium.

.35 For the ceding insurer, if the net cost of a ceded reinsurance contract exceeds the expected value of the recovery (including a risk adjustment in the IASB model), this excess would be recognized as a composite margin (residual margin in the IASB model) in the reinsurance asset. However, if the net cost of the reinsurance is less than the expected value of the recovery (including a risk adjustment in the IASB model), this would be recognized as an immediate gain. Ceding commission would be treated as a reduction of the premium ceded to the reinsurer.

.36 The risk of non-performance by the reinsurer should be included on an expected value basis when estimating the fulfillment cash flows of the reinsurance asset.

.37 As provided in existing US GAAP and IFRS 4, an insurer would not offset reinsurance assets against insurance contract liabilities in the statement of financial position or offset income or expense from reinsurance contracts against the income or expense from insurance contracts.

PwC Observation: While issuing a direct insurance contract cannot give rise to recognition of an initial profit, the proposals do allow a profit to be recognized when purchasing a reinsurance contract. Some argue that this is inconsistent with the treatment for financial instruments and with revenue recognition guidance.

The proposals do not provide any more guidance than current US GAAP and IFRS 4 on whether insurance companies providing fronting arrangements of linked insurance and reinsurance contracts should treat the inwards and outwards contracts as separate transactions or as a single contract for the purpose of applying the definition of insurance contracts and assessing the significance of insurance risk transfer. The IASB application guidance notes that “contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract.”

There may not be symmetry between the measure of the reinsurance asset by the cedant and the insurance liability as measured by the reinsurer for quota share reinsurance. Differences may arise from the assessment of the explicit risk adjustment due to the level of risk diversification reflected or other entity specific assumptions. In addition, the reinsurer may include cash flows for contracts not yet written by the cedant.

Unbundling

.38 An insurer would be required to unbundle components of a contract that are not closely related to the insurance coverage specified in that contract. In particular, under the FASB and IASB proposals the following components would be unbundled:

- Policyholder account balances that are credited with an explicit return where the crediting rate is based on the performance of a specified pool of assets. The crediting rate must pass on all investment performance and so the imposition of a ceiling on the return would not meet these criteria.
- Embedded derivatives that are separated from the host contract in accordance with existing bifurcation requirements for derivatives.
- Goods and services provided under the contract that are not closely related to the insurance coverage but have been combined for reasons that have no commercial substance.

PwC Observation: Unbundling is an important aspect of the proposed accounting as the insurance measurement model differs from other measurement models (i.e., financial instrument and service revenue models). The unbundling requirements are not accompanied by application guidance and hence policyholder account balances, charges and other assessments, cross subsidies, and other terms used in the proposals, including “*closely related*,” will be open for interpretation. It is also unclear how any acquisition costs would be allocated between the different components. Further, the boards' discussions seemed to include an intention to unbundle universal life contracts into separate insurance and financial instrument components. However, some interpret the crediting rate criteria to preclude unbundling account balances that do not receive all the investment return from the associated assets.

.39 The proposals require that in unbundling an account balance, an insurer regard all charges and fees assessed against the account balance as belonging to either the insurance component or another component, but not the investment component. The crediting rate used to determine the account balance is calculated after eliminating any cross-subsidy between that rate and charges or fees assessed against the account balance.

PwC Observation: It is assumed that the account balance could be an asset such that loans under which the outstanding balance is waived upon death or disability could be unbundled into the loan balance (within the scope of financial instruments accounting) and an insurance element (within the scope of the insurance proposals) if they meet the crediting rate criteria.

Discretionary participating features

.40 The IASB and FASB proposals include within their scope insurance contracts issued by insurers that provide the policyholder with both guaranteed benefits (for example, a death benefit) and a right to participate in the favorable performance of the relevant class of contracts, related assets, or both – “discretionary participation features.” The proposals note 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).

.41 Insurers also issue investment contracts with participating features that are not insurance contracts, but give the policyholder guaranteed benefits and additional benefits, which are, to a varying degree, at the discretion of the insurer. The IASB ED includes these contracts in its scope if there are also insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets, or the profit of the same company, fund, or other entity. Otherwise such contracts would be within the scope of the financial instruments standard. The FASB would include all investment contracts with discretionary participating features within the financial instruments standard.

PwC Observation: Participating contracts often include guarantees. The proposals acknowledge that where cash flows depend on the performance of particular assets, the measurement of the insurance contract should reflect that interdependence and this could be through the use of a replicating portfolio technique. It is assumed that guarantees included in contracts with participating features will be measured on a market consistent basis. This could result in a fairly significant liability attaching to the guarantees compared to the measurement under existing accounting policies.

.42 If investment contracts with discretionary participating features are within the scope of the insurance contracts standard, the boundary of the contract is the point at which the contract

holder no longer has a contractual right to receive benefits from the participating features in that contract.

.43 Under the IASB ED, the residual margin on investment contracts with discretionary participating features is recognized in the income statement over the life of the contract on a systematic basis (passage of time or on the basis of the fair value of the assets under management if that pattern differs significantly from the passage of time).

PwC Observation: The guidance in the exposure draft suggests that the expected cash flows would include payments to current or future policyholders as a result of participation features. It is not clear how future contracts would be within the boundary of existing contracts and what the implications of this would be for mutual insurers or inherited estates.

Recognition and derecognition

.44 The IASB and FASB proposals are consistent with regard to recognition and derecognition of insurance contracts. An insurer would recognize an insurance contract at the earlier of when the insurer is bound by the terms of the contract or when the insurer is exposed to the risk under the contract.

PwC Observation: Whether an insurer is bound by an insurance contract will depend on the legal requirements in the territories in which it operates. The period an insurer is exposed to the risk under the contract may not be the same as the insurance coverage period. The recognition criteria will change the way many insurers, especially reinsurers, account for insurance contracts, as contracts will be recognized earlier than the date on which the insurance coverage commences. During the period between the recognition date and the date coverage commences, the insurer would be required to remeasure its obligations using current estimates, including changes in discount rates, and record changes in those obligations in the financial statements. For contracts measured using the simplified approach, the insurer would be required to perform a liability adequacy test, which could result in recognizing a loss in the income statement. The insurer would not commence the amortization of the composite margin (or residual margin) until the coverage period commences.

.45 An insurer would derecognize an insurance contract liability (or a part of an insurance contract liability) when it is extinguished. This is when the obligations in the contract are discharged, cancelled, or expire. At this point the insurer is no longer at risk and is no longer required to transfer any economic resources to satisfy the insurance obligation.

PwC Observation: Reinsurers that write treaties covering a cedant's insurance contracts to be issued in the upcoming year at a constrained price would be required to recognize the contract in accordance with the measurement model, i.e., estimating expected cash flows for underlying direct contracts that have not yet been written. However, entering into a reinsurance agreement does not result in derecognition of the insurance contract liability unless there is a novation of the direct contract. Unlike US GAAP and existing IFRS in respect of financial instruments, the proposals do not contain any guidance on when a substantial modification to an insurance contract should be accounted for as an extinguishment of the contract.

Portfolio transfers and business combinations

.46 The FASB and IASB proposals require an insurer to measure a portfolio of insurance contracts acquired in a portfolio transfer at the higher of:

- The consideration received after adjusting for any other assets or liabilities acquired in the same transaction. In this case the excess of the consideration over the present value of the fulfillment cash flows (including a risk adjustment in the IASB model) establishes the composite margin (or the residual margin in the IASB model) at initial recognition; or
- The present value of the fulfillment cash flows (including a risk adjustment in the IASB model). If the present value of the fulfillment cash flows exceeds the consideration received, the excess results in a loss, which is recognized immediately in the income statement.

.47 A portfolio of insurance contracts acquired in a business combination will be measured at the higher of:

- The fair value of the portfolio. In this case the excess of fair value over the present value of fulfillment cash flows (including a risk adjustment in the IASB model) establishes the composite margin (or the residual margin in the IASB model); or
- The present value of the fulfillment cash flows (including a risk adjustment in the IASB model). If this amount exceeds the fair value of the portfolio, the excess would increase the amount of goodwill.

PwC Observation: The proposals deviate from the principles in US GAAP and IFRS business combination guidance in that the insurance contracts may not be measured at fair value in some instances but instead would be subject to the same principles as applied to other insurance contracts issued by the insurer. The current practice of recognizing a separate asset for the value of business acquired (VOBA or PVIF) would be eliminated.

Unit-linked contracts

.48 A unit-linked contract (sometimes called a separate account or variable contract) is one where some or all of the benefits are determined by the price of units in an internal or external investment fund. Under the IASB and FASB proposals, unit-linked assets and liabilities would be presented as separate line items in the statement of financial position and not commingled with the insurer's other assets and liabilities. Income and expense from unit-linked contracts would be presented as a single line item in the income statement. Income and expense from pools of assets underlying these contracts would be presented as a single line item as well, not commingled with income and expense from the insurer's other assets.

.49 In proposed amendments to IFRS 9, IAS 32, and IAS 16, the IASB would require entities to recognize treasury shares and owner occupied property at fair value with changes in fair value recognized in profit or loss to the extent those fair value changes relate to the interest of unit-linked contract holders in the pool of assets. While the FASB had agreed to this accounting during deliberations, there is no discussion of this issue in the FASB DP.

PwC Observation: Both insurance contracts and other financial instruments can meet the unit-linked contract definition. It is unclear how the unbundling rules for account balances link with the presentation requirements for unit-linked contracts. The boards' intent seemed to be for this presentation to apply to the account balance of a unit-linked contract. However, the proposals require any unbundled account balances within unit-linked contracts to be accounted for under the financial instruments standard. Similarly, the single line presentation would also not apply to unit-linked investment contracts unless a similar requirement were to be included in financial instruments guidance. Further, the proposed amendments to IFRS 9, IAS 32, and IAS 16 refer to treasury shares issued by

and property occupied by an insurer. It is not clear whether these amendments would apply only to insurance contracts or whether they would also apply to unit-linked investment contracts.

Presentation: Statement of comprehensive income

.50 The following minimum line items would be required to be presented in the statement of comprehensive income under both the FASB and IASB proposals:

- Underwriting margin (i.e., the release of the composite margin under the FASB model). Under the IASB model, the underwriting margin would comprise both the change in the risk adjustment and the release of the residual margin, disaggregated in the income statement or the notes. Gains and losses at initial recognition, disaggregated in the income statement or the notes into losses on portfolio transfers, gains on buying reinsurance, and day one losses.
- Non-incremental acquisition costs.
- Experience adjustments and changes in estimates, disaggregated in the income statement or the notes into experience adjustments, changes in cash flow estimates and discount rates, and reinsurance impairment losses.
- Interest on insurance liabilities (presented to highlight the relationship with investment return on assets backing those liabilities).

.51 Under the IASB proposal, for the pre-claim liability when the short-duration contract approach is used, the insurer should present:

- Underwriting margin (disaggregated in the income statement or the notes into premium revenue, being the reduction in the pre-claim liability from providing insurance coverage, claims incurred, expenses incurred, and amortization of incremental acquisition costs).
- Changes in liability for onerous contracts.

.52 Other than for the pre-claim liability as noted above, premiums, claims expenses, and other expenses included in the measurement of the liability are not presented in the statement of comprehensive income but are treated as deposit receipts/payments under both the FASB and IASB proposals.

PwC Observation: The presentation model is driven by the measurement model. For many insurers, the proposed statement of comprehensive income will be a significant change from the way insurers present their results today. Property and casualty insurers that write contracts accounted for under the simplified measurement approach and also write contracts measured under the building block measurement model will not be able to show premium income on all insurance contracts on the face of the income statement. Conglomerate groups will also need to consider how they will present their combined results. It is unclear how subsequent changes in the claims liability would be presented in the simplified measurement approach underwriting margin, as these liabilities are under the building block measurement model.

Management, analysts, and investors will need to be educated in the new presentation format and the implications of the building blocks approach on reported earnings. It will take some time to become accustomed to not having premiums, claims, incremental acquisition costs, and administrative expenses (to the extent they are included in the building block cash flows) presented on the face of the income statement.

Disclosure

.53 Under the FASB and IASB proposals an insurer would disclose qualitative and quantitative information about the amounts recognized in the financial statements and the nature and extent of risks arising from insurance contracts to help users understand the amount, timing, and uncertainty of future cash flows arising from those contracts. An insurer should aggregate or disaggregate information so that useful information is not obscured. The proposed disclosure requirements build on the current IFRS 4 requirements and have been amended to also require the following disclosure that flows from the measurement model.

.54 The proposals require a reconciliation from the opening to the closing aggregate insurance and reinsurance balances for each of the following:

- (a) Insurance contract liabilities and assets
- (b) Risk adjustments included in (a)
- (c) Residual (or composite) margins included in (a)
- (d) Reinsurance assets arising from reinsurance contracts held as cedant
- (e) Risk adjustments included in (d)
- (f) Residual (or composite) margins included in (d)
- (g) Impairment losses recognized on reinsurance assets

.55 Each reconciliation as required above should show at a minimum:

- The carrying amount at the beginning of the period
- New contracts recognized during the period
- Premiums received
- Payments with separate disclosure of claims, expenses, and incremental acquisition costs
- Other cash paid
- Income and expenses recognized in profit or loss
- Amounts relating to portfolio transfers or business combinations
- Net exchange differences arising from translation of foreign currency amounts

.56 An insurer should disclose the methods used and processes for determining the inputs to the fulfillment cash flows. Under the IASB proposal, an insurer should also disclose the methods and inputs to determine the risk adjustment, including disclosure of the confidence level to which the risk adjustment corresponds (when the insurer uses the conditional tail expectation or cost of capital methods).

.57 The proposals also include a requirement to disclose a measurement uncertainty analysis of the inputs that have a material effect on the measurement. If changing one or more of the inputs in the building blocks to a different amount that could reasonably have been used in the circumstances would have resulted in a materially different measurement,

the insurer would be required to disclose that effect. In determining this effect the insurer should ignore remote scenarios but include the effect of correlation between inputs. Significance is judged with reference to profit or loss and total assets or total liabilities.

.57 The disclosure about the nature and extent of risks arising from insurance contracts are similar to current IFRS 4 requirements for insurance contracts but would be expanded to require disclosure about information on the regulatory framework in which the insurer operates, for example, minimum capital requirements or required interest rate guarantees.

.58 The proposed disclosure requirements would retain the IFRS 4 requirement to present claims development tables, initially for at least 5 years. After adoption of the standard, claims development tables would be built up to 10 years. The requirement would not apply to claims that are settled within one year.

PwC Observation: The proposed disclosure requirements are more detailed than currently required and may significantly impact the system requirements of insurers. Systems will have to be able to capture and produce information sufficient to present the reconciliation of movements in the insurance and reinsurance balances.

Transition

.59 Because the FASB proposal is merely a discussion paper rather than an exposure draft, no transition guidance is provided. However, the IASB ED envisages retrospective application for all in-force contracts with no grandfathering of past practices. At the beginning of the earliest period presented, an insurer would:

- Measure each portfolio of insurance contracts at the present value of the fulfillment cash flows (including a risk adjustment), which would exclude any residual margin
- Derecognize any existing balance of deferred acquisition costs
- Derecognize any intangible assets arising from insurance contracts assumed in previous business combinations (excluding customer relationships/lists that relate to future contracts)

.60 At the start of the earliest period presented, when the insurer would first apply the proposed standard, insurers would be permitted to redesignate a financial asset as measured at fair value with changes in fair value recognized in profit and loss but not to redesignate a financial asset that is currently measured at fair value with changes in fair value recognized in profit or loss to amortized cost.

PwC Observation: The extent of the opening retained earnings adjustment on the initial application of the IASB standard will be influenced by many factors, including the profitability of the business written as well as the previous accounting policies applied (including the level of prudence in those previous measurements). Insurers that write longer term contracts are likely to be concerned that profit in excess of the risk adjustment that would have been recognized in the income statement in future periods will now be recognized in equity on transition. As a result of these transition provisions, contracts in-force at transition will have less profit in future periods than new business due to the lack of a residual margin being recognized at transition. The proposed standard does not allow insurers to implement the proposals in full retrospectively.

Timing for comments

.61 The comment period on the FASB discussion paper ends on December 15, 2010 (or November 30, 2010 for roundtable participants). The comment period for the IASB's exposure draft ends on November 30, 2010, and a final IASB standard is expected in mid-2011. Given the potential impact of the proposed changes, we encourage management to engage in the comment letter process and respond formally to the boards on the questions included in both the FASB discussion paper and the IASB exposure draft.

Where to go for more information

.62 The [IASB exposure draft](#) and [FASB discussion paper](#) can be found on the IASB's website and the FASB's website, respectively.

Questions

.63 PwC clients who have questions about this DataLine should contact their engagement partner. Engagement teams that have questions should contact a member of the Financial Instruments Team in the National Professional Services Group (1-973-236-7803).

DataLine

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