Practical guide to IFRS

23 August 2010

Insurance contracts

Fundamental accounting changes proposed

At a glance

- The IASB (‘the board’) released an exposure draft on 30 July 2010 proposing a comprehensive standard to address recognition, measurement, presentation and disclosure for insurance contracts. The FASB is expected to issue a discussion paper shortly.

- The proposals will apply to all entities that issue insurance contracts, not just insurers. The proposals retain the IFRS 4 definition of an insurance contract but amend the scope to exclude fixed fee service contracts but some financial guarantee contracts may now be within the scope of the proposed standard.

- The proposals would require an insurer to measure its insurance contracts using a current measurement model (that is one where current estimates are re-measured each reporting period).

- The measurement approach is based on the following building blocks: a current, unbiased and probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract; the effect of time value of money; an explicit risk adjustment and a residual margin calibrated so that no profit is recognised on inception.

- A simplified measurement approach is required for the unexpired coverage period for short-duration contracts in which the coverage period is approximately one year or less but is not available for other contracts.

- The board expects to issue the final standard in mid 2011 but has not yet proposed an effective date. Retrospective application will be required but with some practical expedients for transition.

- Management will need to evaluate how the proposed standard will impact current business practices, investor communications and assess the additional demands of the new model on data and modelling systems.

Introduction

1. The board's objective is to develop a single high-quality standard addressing recognition, measurement, presentation and disclosure for insurance contracts. In 2007 the board issued a discussion paper. It has now issued an exposure draft of the standard that will replace IFRS 4, 'Insurance contracts', which was an interim standard that permits a variety of accounting practices for insurance contracts. The objective of the exposure draft to have a single comprehensive model is likely to be welcomed by the IFRS reporting insurance industry, both by preparers and analysts given the diversity of insurance accounting today. The exposure draft proposes a single comprehensive measurement approach for all types of insurance contracts issued (and reinsurance contracts held). The proposals retain the IFRS 4 definition of an insurance contract.

2. Except for certain short-duration contracts, the measurement model for insurance contracts 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 discounted cash flows and risk adjustment are re-measured at each reporting period. Short-duration contracts of approximately one year or less are measured as premiums less any incremental acquisition costs for the unexpired coverage. For such contracts claims liabilities that arise are measured using the building block approach (without a residual margin).

PwC observation: The proposals replace the exit value notion from the discussion paper with an approach that considers the cash flows that will arise as the insurer fulfils the contract over time. Another key difference from the discussion paper is that the proposed residual margin approach prevents the recognition of a day one profit.

The proposed guidance will impact some insurers more than others, but all insurers are likely to be affected. The following areas are likely to be different from existing accounting practices for many insurers:

- A current measurement model where estimates are re-measured each reporting period
- Single point estimates may no longer suffice
- Most liabilities will be discounted using a current interest rate
- All acquisition costs no longer deferred as an asset and non-incremental acquisition costs expensed
- Unbundling of some investment components and embedded derivatives

3. The comment period ends on 30 November 2010.

4. In October 2008 the FASB joined the project and since then both boards have been jointly discussing the proposals. The FASB will issue a discussion paper that incorporates the IASB proposals alongside its alternative views. This is also expected to have a comment period to 30 November 2010.

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 urgent need to address the accounting for insurance contracts is therefore not as pronounced as for IFRS preparers.

There are two key areas of difference between the FASB and IASB proposals which are considered in more detail in this document. The first is 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. The second area of difference is the FASB's preference to exclude all investment contracts with discretionary participating features from the scope of the proposals.

Key provisions

Definition and scope

5. The proposed standard would apply to all entities that issue insurance contracts, not just insurers. 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". 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". Whilst the board retained the IFRS 4 definition it did amend the guidance in IFRS 4 to clarify that a contract will 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 premium.

PwC observation: The clarification of the guidance may mean that certain contracts that guarantee a return of premium may no longer meet the definition of an insurance contract. We are not currently aware of other contracts meeting the definition in IFRS 4 that will not meet the amended definition.

Some banks issue loans that include a waiver of the outstanding loan balance on death or disability of the customer. These contracts are likely to meet the definition of an insurance contract, as they do under IFRS 4, but the extent to which they are affected by the proposals will depend on the unbundling rules contained within the proposals, as discussed later in this document.

6. The board has continued to exclude certain contracts that meet the definition of insurance contracts from the scope of the standard. 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 employee benefit plans; and
- insurance contracts that an entity holds as a policyholder (although a cedant will apply the proposals to reinsurance contracts that it holds).

7. IFRS 4 defined a financial guarantee contract as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make a payment when due. IFRS 4 permitted insurers that issued such contracts to treat them as insurance contracts although other institutions treated them as financial instruments. The board will now require all contracts that meet the insurance contract definition (and are not specifically exempted) to be accounted for as insurance contracts. The definition of a financial guarantee contract will be deleted from IAS 39 and the proposed insurance contracts standard so that any guarantee contracts that do not meet the insurance contract definition will be within the scope of IAS 39.

8. The board is proposing an amendment to the scope in IFRS 4 to 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 contacts in which the insurer provides goods and services to the policyholder to compensate the policyholder for insured events.

PwC observation Financial guarantee insurance, mortgage guarantee insurance, trade credit insurance and some letters of credit often issued by banks will now be within the scope of the standard. 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 will continue to be accounted for as financial instruments. Whilst the insurance contract accounting may be different from the current accounting for financial guarantee contracts that are within the scope of IAS 39, the resulting measurement may not be significantly different from the accounting that would be required under IFRS 9.

It is clear that the board intended for fixed fee service contracts (such as roadside assistance contracts and repair services) to be outside of the scope of the insurance contract 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 proposed standard. There will be some contracts not specifically mentioned in the guidance where it will be unclear whether they are in the scope of the insurance contracts standard.

9. The scope of the proposed standard includes financial instruments containing discretionary participating features. These are considered further in the section on discretionary participating features below.

Measurement model

10. The exposure draft proposes a single measurement model for all insurance contracts that portrays a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects its existing insurance contracts to generate as it fulfils its rights and obligations under the contract. This measure is referred to in the proposals as the "present value of the fulfilment cash flows" which is measured using 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.
- An explicit risk adjustment to reflect the estimate of the effects of uncertainty about the amount and timing of those future cash flows.

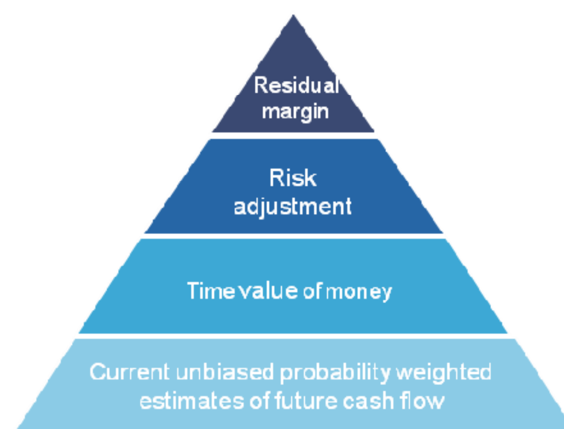

Figure1: Measurement model

11. The board has concluded that there should be no 'day one' profit recognition for insurance contracts, to be consistent with the proposals within the revenue recognition project. As a result if the above calculation gives rise to an 'asset' a residual margin is added to eliminate any day one gain and therefore the contract is measured initially at nil. If the present value of the fulfilment cash flows is greater than zero the insurer recognises that present value as a loss, as it represents a loss on an onerous contract. Subsequent changes in the present value of fulfilment cash flows could create an insurance asset or liability.

12. In the model preferred by the FASB there is no explicit risk adjustment instead a composite margin is established to eliminate any gain at inception. Any excess of expected cash outflows over expected cash inflows would be recognised immediately as a loss.

PwC observation: In the FASB composite model a loss on day one is recognised when expected cash out flows are greater than the expected cash inflows. The IASB model may recognise a loss in situations where the FASB model would not because the FASB model does not include an explicit risk adjustment in the measurement of expected cash flows.

13. The exposure draft proposes an insurer to treat insurance contracts in a foreign currency as monetary items when applying IAS 21. The requirement applies to the fulfilment cash flows, the risk adjustment and the residual margin.

PwC observation: This will be a welcome change that will eliminate the accounting mismatches that arose under IFRS 4 when unearned premiums and deferred acquisition costs were treated as non-monetary items by property and casualty insurers.

Cash flows

14. The cash flows included in the fulfilment cash flows are an explicit, unbiased and probability weighted estimate of the incremental future cash outflows less future cash inflows that will arise as the insurer fulfils 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 modelling may be needed.

15. The cash flows should include all incremental cash inflows and outflows arising from a portfolio of insurance contracts. These 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 overheads and income tax payments and receipts which are recognised and measured under IAS 12, 'Income taxes'. Cash flows should be current and reflect the perspective of the insurer, except for market variables, which should be as consistent as possible with observable market prices. The application guidance notes that the use of a replicating portfolio (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 fulfils 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 exposure draft proposes that estimated cash flows are 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.

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 behaviour including features that allow policyholders to take actions to change the amount, timing or nature of the benefits they will receive and risk adjustments for the uncertainty of policyholder behaviour.

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. This will require a significant change to most valuation models and systems which generally do not incorporate a range of scenarios but often only measure a single point estimate. Insurers will need to understand the pressure that this will place on the valuation system and reporting timelines.

The definition of the contract boundary could have an impact on certain health and other contracts where the regulator imposes constraints on re-pricing for individual policyholders. In some territories these contracts are currently treated as short-duration contracts but under the above proposals the expected cash flows may extend beyond the one year boundary if the insurer cannot fully re-price and re-underwrite the individual policyholder.

Alternatively, there may be contracts that are currently treated as long term 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 recognised.

Income tax payments and receipts which are recognised and measured under IAS 12, 'Income Taxes' are not included in the cash flows. In some territories policyholder benefits are dependent on future net of tax investment returns. The proposals will not allow these future tax flows to be reflected in the measurement of the liability. The cash flows will also exclude investment returns and the associated investment expenses as the investments are recognised and presented separately.

In some countries insurers issue policy loans to customers secured against the insurance contracts. Insurers will need to consider whether these loans represent cash flows under the insurance contract or whether they are separate financial instruments that would be accounted for under IAS 39 or IFRS 9.

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 be the risk free yield curve 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 fulfilment cash flows should not reflect the risk of non-performance of the insurer.

PwC observation: The recent credit crisis has highlighted the difficulty in distinguishing between illiquidity and credit risk within market prices. In valuing insurance liabilities there will be contracts which 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 for insurers will be to determine when it is appropriate to apply an adjustment for illiquidity for those contracts that fall in between these two extremes.

In addition there 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 board is asking for specific comments on whether the fulfilment cash flows should reflect the non-performance risk of the insurer. In responding to this proposal insurers will need to consider the impact of IFRS 9 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 the deliberation on the insurance contracts project was whether or not, 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 effect of uncertainty inherent in the estimated future cash flows. After much deliberation the board 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 proposals therefore include 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 fulfilment 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 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 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 proposals require the risk adjustment to be measured at a portfolio level. A portfolio is defined as “insurance contracts that are subject to broadly similar risks and managed together as a single pool.” The adjustment will therefore allow for risk diversification within that portfolio but not between different portfolios within a group.

PwC observation: If the cost of capital approach is applied, it 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. It also reduces the amount of the residual margin which is amortised.

The challenge for insurers to reliably and consistently measure the risk adjustment will vary from territory to territory depending on whether similar risk adjustments 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.

Subsequent measurement and residual margin

23. At the end of each reporting period, the insurance liability will be measured as the sum of the present value of fulfilment 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 recognised immediately in the income statement.

24. The residual margin is calibrated at inception to an amount that avoids a gain being recognised 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 recognised 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.

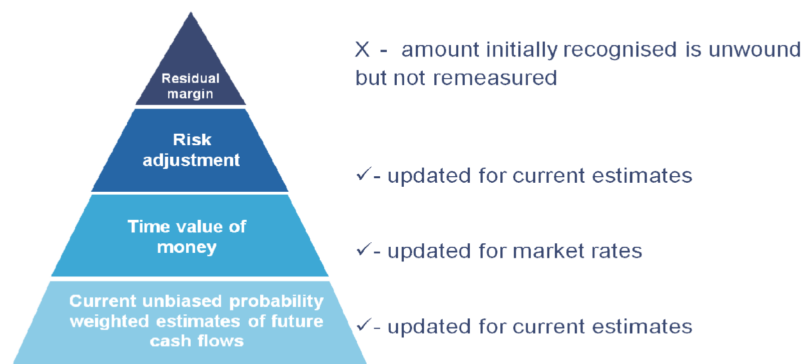

Figure 2: Subsequent measurement

25. 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: Recognising 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. The board did not allow any changes in estimates to be recognised in other comprehensive income (OCI) unlike IFRS 4. Some argue that this could result in accounting mismatches where assets are measured on an amortised cost basis or equities are measured at fair value through OCI.

One criticism of the proposals is that a gain on initial recognition is not permitted to be recognised in the income statement, yet if there is a positive change in the estimates of cash flows on day two then this would be recognised immediately in the income statement.

The board 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 model the residual margin could be restated as at inception of the contract and amortised over the coverage period but with

updated experience (up to the reporting date) and assumptions of future cash flows. This would lead to part of the change in estimates being recognised immediately in the income statement and the remainder adjusting the unamortised portion of the residual margin and so would be recognised over the remaining coverage period. However, such an approach would be complex to model for long term contracts.

The proposal requires that the residual margin is recognised in the income statement over the coverage period in a systematic manner. However, it is not clear in the proposals whether the pattern of amortisation can change. For example can the residual margin be released if the occurrence of a claim means that the risk of any further claim is reduced or eliminated?

26. 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 amortised over both the coverage and claims handling period according to the formula:

$$\frac{\textit{Premium allocated to current period} + \textit{Current period claims and benefits}}{\textit{Total contract premium} + \textit{Total claims and benefits}}$$

The composite margin would not be re-measured to reflect any changes in risk and uncertainty. Interest would not be accreted on the composite margin.

PwC observation: Supporters of the composite margin approach argue that this approach avoids the concern that a risk adjustment is inconsistent with the fulfilment objective of the standard. 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

27. Acquisition costs that arise from and are incremental to an individual contract are included in the present value of fulfilment 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 fulfilment cash flows will reduce the residual margin 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 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.

The proposals will 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 commission which is usually incremental at the contract level and so will be a fulfilment cash flow in the building block approach. This treatment will result in the reduction of the recognised residual margin on day one. When the commission is paid, it will be treated as a contract cash flow in 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 residual margin for a contract that is recognised over the coverage period and will expense most of their acquisition costs immediately, which could give rise to an initial loss.

Life insurers that issue both insurance and investment contracts will have a different accounting treatment for acquisition costs on the different contracts. Currently commission incurred on selling investment contracts is often deferred under IAS 18. The Revenue Recognition exposure draft is likely to result in these costs being immediately expensed. Both treatments are different from the inclusion of the costs as a contract cash flow within the insurance contract proposals. The difference in reported profits between the current IAS 18 treatment and the proposed insurance contracts standard will depend on the extent to which the current deferred acquisition cost amortisation pattern differs from the amortisation of the residual margin.

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

28. The proposals require that short-duration contracts of approximately one year or less that do not contain any embedded derivatives or options will have the pre-claims obligation measured as the premium received at initial recognition plus the expected 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. Any claims that arise on these contracts will be measured at the present value of the fulfilment cash flows using the building block model, as for all other insurance contracts.

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

30. The pre-claim obligation is reduced over the coverage period in a systematic way that reflects the exposure from providing insurance coverage. Similar to the residual margin in the building block model, this will be amortised on the basis of passage of time or on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time. Interest will accrete on the pre-claims liability at the current rate.

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

The exposure draft is unclear 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.

The onerous contract test is performed for a portfolio of contracts with a similar date of inception. This may be at a lower level than current accounting practice would require. The definition of a portfolio may be open to different interpretations.

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.

Reinsurance

31. The proposals require that reinsurance business assumed should be measured using the same building block measurement approach as for other insurance contracts. Ceding commission paid to the ceding company is treated as a reduction in premium.

32. For the ceding insurer, if the net cost of a ceded reinsurance contract exceeds the expected value of the recovery (including a risk adjustment) then this excess is recognised as a residual margin 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) then this is recognised as an immediate gain. Ceding commission is treated as a reduction of the premium ceded to the reinsurer.

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

34. As required by IFRS 4, an insurer shall 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: Whilst issuing a direct insurance contract cannot give rise to recognition of an initial profit, the proposals do allow a profit to be recognised when purchasing a reinsurance contract. Some argue that this is inconsistent with the treatment for financial instruments and revenue recognition, as well as direct insurance contracts.

The proposals do not provide any more guidance than 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 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 measurement 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

35. 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 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 IAS 39.
- 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.

36. The proposals require unbundling an account balance an insurer shall regard all charges and fees assessed against the account balance as belonging to either the insurance component or another component, but are not part of 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: Unbundling is an important issue as the insurance measurement model differs from other measurement models (that is 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.

The board 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.

It is assumed that the account balance could be an asset such that loans which waive the outstanding balance on death or disability could be unbundled into the loan balance (in the future scope of IFRS 9) and an insurance element (within the scope of the insurance standard) if they meet the crediting rate criteria.

Discretionary participating features

37. The draft standard includes within its 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 standard proposes 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 (that is, on an expected present value basis).

38. 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 exposure draft 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 will be within the scope of the financial instruments standard. The FASB would include all investment contracts with discretionary participating features within the financial instrument standard.

39. 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.

40. The residual margin on investment contracts with discretionary participating features is recognised 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 terms of participating contracts vary from territory to territory. Companies will need to assess whether their investment contracts with participating features share in the same pool of assets as participating insurance contracts, particularly in determining where to apply the dividing line (for example when a limited/immaterial amount of participating insurance contracts share in the same pool of assets).

In some territories contracts permit policyholders to switch invested funds between unit linked funds and funds that contain discretionary participating features. Consideration will need to be given as to whether these meet the requirement to be within the scope of the insurance contract standard if they are initially invested in unit linked funds.

The guidance in the exposure draft suggests that the expected cash flows will 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.

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 shall 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.

Recognition and derecognition

41. An insurer recognises an insurance contract at the earlier of when the insurer is bound by the terms of the contract and when the insurer is exposed to the risk under the contract.

42. An insurer will derecognise 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: Whether an insurer is bound by an insurance contract will depend on the legal requirements in the different territories in which they operate.

The period an insurer is exposed to the risk under the contract is not 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 recognised earlier than the date on which the insurance coverage commences. During this period, the insurer is required to perform a liability adequacy test which could result in recognising a loss in the income statement or recognise changes in assumptions and discount rates, but the insurer will not commence the amortisation of the residual margin until the coverage period commences.

Reinsurers that write treaties covering a cedant's insurance contracts to be issued in the upcoming year at a constrained price will be required to recognise the contract in accordance with the measurement model, i.e. estimating expected cash flows for underlying direct contracts that have not yet been written.

Entering into a reinsurance agreement does not result in the derecognition of the insurance contract liability unless there is a novation of the direct contract.

Unlike IAS 39 in respect of financial instruments and US GAAP, the exposure draft does 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

43. The proposed standard requires 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 fulfilment cash flows establishes the residual margin at initial recognition; or

- the present value of the fulfilment cash flows. If the present value of the fulfilment cash flows exceeds the consideration received, the excess results in a loss which is recognised immediately in the income statement.

44. 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 fulfilment cash flows establishes the residual margin; or

- the present value of the fulfilment cash flows. If this amount exceeds the fair value of the portfolio the excess will increase the amount of goodwill.

PwC observation: IFRS 3 will be amended as the proposals in the exposure draft deviate from the principles in IFRS 3 in that the insurance contracts may not be measured at fair value but instead subjected to the same principles as applied to other insurance contracts issued by the insurer.

The current practice of recognising a separate asset for the value of business acquired (VOBA or PVIF) will be eliminated.

Unit-linked contracts

45. A unit-linked contact (sometimes called 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. The proposals are that unit-linked assets and liabilities will be presented as separate line items in the statement of financial position and not co-mingled with the insurer's other assets and liabilities. Income and expense from unit-linked contracts will be presented as a single line item in the proposals.

46. In proposed amendments to IFRS 9, IAS 32 and IAS 16, the board will require entities to recognise treasury shares and owner occupied property at fair value through profit or loss to the extent those fair value changes relate to the interest of unit-linked contract holders in the pool of assets.

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 board's 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 and therefore would not be within the scope of the single line presentation requirement included in the insurance contracts standard. Similarly, the single line presentation would also not apply to unit-linked investment contracts unless a similar requirement was included in IAS 1 or the financial instruments standard.

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 therefore not clear whether these amendments will apply only to insurance contracts or whether they will also apply to unit-linked investment contracts.

Presentation

Statement of comprehensive income

47. The following minimum line items must be presented in the statement of comprehensive income:

- Underwriting margin, disaggregated in the income statement or the notes into the change in risk adjustment and the release of the residual margin.
- 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 due to the liability adequacy test.
- 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).

	Inception 1 January	Six months to 30 June	Six months to 31 December
Change in risk margin		21	26
Residual margin		13	13
Underwriting margin	-	34	39
Acquisition costs	10	-	-
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Net gain at inception	-	0	0
Investment income		40	38
Interest on insurance liability	-	(25)	(23)
Profit/(Loss)	(10)	19	44

Figure 3: Income statement presentation

48. 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 amortisation of incremental acquisition costs).
- Changes in liability for onerous contracts.

49. 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.

PwC observation: The presentation model is driven by the measurement model. For those insurers that do not currently use embedded value information, 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 model 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 are presented in the simplified measurement model 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 implication 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

50. Under the proposals an insurer would disclose qualitative and quantitative information about the amounts recognised 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 insurance 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.

51. The exposure draft requires a reconciliation from the opening to the closing aggregate insurance and reinsurance balances for each of the following:

(a) Insurance contract liabilities and separately assets.

(b) Risk adjustments included in (a).

(c) Residual margins included in (a).

(d) Reinsurance assets arising from reinsurance contracts held as cedant.

(e) Risk adjustments included in (d).

(f) Residual margins included in (d).

(g) Impairment losses recognised on reinsurance assets.

52. Each reconciliation as required above should show as a minimum:

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

53. As part of the disclosure of the methods used and processes for determining the inputs, an insurer should 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).

54. The exposure draft also includes 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 is 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.

55. The disclosure about the nature and extent of risks arising from insurance contracts are similar to the current requirements but have been 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.

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

PwC observation: The above disclosure requirements are more detailed than currently required and may significantly impact on 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.

Analysts are always interested in the free cash flows of an insurer, which are the cash flows that are generated which are not for the benefit of policyholders. The disclosure requirements in the exposure draft do not make any distinction between shareholder and policyholder cash flows.

Transition

57. The proposed standard envisages full 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 fulfilment cash flows (including a risk adjustment) which will exclude any residual margin.
- Derecognise any existing balance of deferred acquisition costs.
- Derecognise any intangible assets arising from insurance contracts assumed in previous business combinations (excluding customer relationships/lists which relate to future contracts).

58. At the start of the earliest period presented, when the insurer first applies the proposed standard, insurers are permitted to redesignate a financial asset as measured at fair value through profit and loss but not to redesignate a financial asset that is currently measured at fair value through profit or loss to amortised cost.

PwC observation: The extent of the opening retained earnings adjustment on the initial application of the 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 who write longer term contracts are likely to be concerned that profit in excess of the risk adjustment that would have been recognised in the income statement in future periods will now be recognised 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 recognised at transition. The proposed standard does not allow insurers to apply the principle in IAS 8 and implement the proposals in full retrospectively.

The IFRS 9 reclassification is limited to redesignating assets to the fair value through profit and loss category. Some insurers may wish to move assets from the fair value through profit or loss category to amortised cost if the requirement to unbundle account balances from the insurance contract would allow the account balance to be on an amortised cost basis. The proposals will not allow this redesignation to amortised cost.

Timing for comments

Comments on the exposure draft are due by 30 November 2010. We encourage management to engage in the comment letter process and respond formally to the board on the questions included in the exposure draft.

Where to go for more information

A summary of all the tentative decisions reached by the boards relating to this project can be found at http://www.ifrs.org/NR/rdonlyres/AE74059B-25DE-4C85-A14E-5D8AEDFC1E60/0/Decisions_at_a_glance_30July.pdf.

pwc.com/insurance

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