



## **IASB and FASB to discuss account driven contracts, unbundling, results of field testing and presentation on 18 February**

### **Overview**

This month, a significant amount of time is devoted to insurance accounting at the two joint meetings of the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (collectively, the Boards). The first joint meeting, held on 10 February, discussed accounting for reinsurance contracts by both the reinsurer and the cedant as well as possible issues arising from a lack of symmetry between policyholder accounting and accounting by the issuer of an insurance contract. The latter issue results from a request for further analysis by the Boards in October 2009. In these discussions, the Boards tentatively decided not to include policyholder accounting in the scope of the Exposure Draft. They also discussed various questions related to accounting by reinsurers and asked the Staff to bring the topic back to a future meeting.

Discussions on 18 February, the second joint meeting for the month, will look at account driven contracts (e.g., unit linked and universal life contracts), unbundling of insurance contracts, the presentation of the performance statement and the outcome of the first series of field tests.

## The story so far

A summary of topics discussed and tentative decisions by the IASB and FASB to date, are set out in the table below.

Topic	IASB	FASB
<b>Measurement approach</b>	<p>The Boards decided tentatively that the measurement approach should portray a current assessment of the contract, using the following four building blocks:</p> <ul style="list-style-type: none"> <li>▶ The unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligations arising from the insurance contract</li> <li>▶ The time value of money</li> <li>▶ A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows</li> <li>▶ An amount that eliminates any gain at inception of the contract</li> </ul> <p>The Boards also tentatively decided:</p> <ul style="list-style-type: none"> <li>▶ These building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations. That combination of rights and obligations should be presented on a net basis.</li> <li>▶ The objective for measuring an insurance contract should refer to a value rather than cost. The Staff will refine the description of that objective.</li> </ul>	
<b>Risk adjustment</b>	<p>The Boards decided tentatively that the risk adjustment should measure the insurer's view of the uncertainty associated with the future cash flows and clarified that:</p> <ul style="list-style-type: none"> <li>▶ The risk adjustment should be the amount the insurer requires for bearing the uncertainty that arises from having to fulfil the net obligation arising from an insurance contract. The Staff will develop guidance on how to determine the risk adjustment.</li> <li>▶ The risk adjustment should be updated (remeasured) each reporting period.</li> </ul>	
<b>Non-performance risk</b>	<p>The Boards decided tentatively that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer.</p>	
<b>Use of inputs</b>	<p>The Boards decided tentatively that the measurement should:</p> <ul style="list-style-type: none"> <li>▶ Consider all available information that represents the fulfilment of the insurance contract. All available information includes, but is not limited to: industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract.</li> <li>▶ Use current estimates of financial market variables that are as consistent as possible with observable market prices.</li> </ul>	
<b>Exclude discounting and margins in some instances</b>	<p>The IASB noted the arguments for and against an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB considered whether to use such an approach for non-life claims liabilities and tentatively decided not to add it to the list of candidates.</p>	<p>The FASB will consider at a future meeting whether, in certain instances, a measurement of insurance contracts would use future cash flows with no margins and no discounting.</p>
<b>Unearned premium</b>	<p>The IASB decided tentatively:</p> <ul style="list-style-type: none"> <li>▶ An unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts</li> <li>▶ To require, rather than permit, the use of an unearned premium approach for those liabilities</li> </ul>	<p>The FASB will discuss an unearned premium approach at a future meeting.</p>
<b>Measurement of margins at inception</b>	<p>In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.</p> <p>In the proposed accounting approach, a loss arises at inception if, after applying a risk adjustment, the expected present value of cash outflows exceeds the expected present value of cash inflows. The Boards tentatively decided that an entity should recognise that loss in profit or loss at inception.</p>	

Topic	IASB	FASB
<b>Subsequent treatment of margins</b>	<p>The proposed accounting approach eliminates any gain at inception by including a residual margin in the measurement of the combination of rights and obligations arising from the insurance contracts. The Boards tentatively decided:</p> <ul style="list-style-type: none"> <li>▶ To develop specific guidance on how the residual margin should be released to profit or loss over time</li> <li>▶ That the insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates</li> </ul>	
<b>Discount rates</b>	<p>The IASB decided tentatively:</p> <ul style="list-style-type: none"> <li>▶ The discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability, rather than using a discount rate based on expected returns on actual assets backing those liabilities</li> <li>▶ The standard should not give detailed guidance on how to determine the discount rate</li> </ul>	<p>The FASB will discuss this issue further at a future meeting.</p>
<b>Acquisition costs</b>	<p>The Boards decided tentatively that an insurer:</p> <ul style="list-style-type: none"> <li>▶ Should expense all acquisition costs when incurred</li> <li>▶ Should not recognise any revenue (or income) to offset those costs incurred</li> </ul>	
<b>Policyholder behaviour and contract boundaries</b>	<p>The Boards decided tentatively that policyholder options, as well as options, forwards, and guarantees related to existing coverage, should be included in the measurement of the insurance contract on a look-through basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract). As a consequence, no deposit floor would apply. The Staff will develop material to identify the boundary of an existing contract at a later date. The Staff will also perform additional analysis as to whether an option pricing model can be used to measure the contract, to be presented at a future meeting as part of a discussion about risk margins.</p> <p>The Boards also discussed how to treat options, forwards and guarantees that do not relate to the existing insurance contract coverage. The Boards tentatively decided to exclude such features from the measurement of that contract. Instead, those features should be recognised and measured as new insurance contracts or other stand-alone instruments, according to their nature.</p>	
<b>Participating features in insurance contracts</b>	<p>The IASB expressed an initial preference for an approach that includes all cash flows that arise from a participating feature in the measurement of the insurance liability on an expected present value basis.</p>	<p>The FASB expressed an initial preference for an approach that analyses cash flows expected to arise from a participating feature to determine whether those flows are required (e.g., by the contract or by a statute) or are discretionary. Required cash flows (if there are any) will be included in the measurement of the insurance liability. Discretionary cash flows will be recognised when the entity has an obligation to make payments.</p>
<b>Recognition</b>	<p>The IASB discussed the recognition of rights and obligations arising under insurance contracts, including the treatment of the contract in the period (if any) between entering into the contract and the start of the coverage period. No clear consensus emerged. The Boards will return to the topic of recognition at a future meeting.</p>	<p>The FASB tentatively decided that an entity should recognise an insurance obligation at the earlier of:</p> <ul style="list-style-type: none"> <li>▶ The entity being on risk to provide coverage to the policyholder for insured events</li> <li>▶ The signing of the insurance contract</li> </ul>
<b>Derecognition</b>	<p>The IASB discussed derecognition of insurance liabilities and decided tentatively that that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principle in IAS 39 <i>Financial Instruments: Recognition and Measurement</i>.</p>	<p>The FASB tentatively decided on a principle that an insurance liability should be derecognised by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.</p>

Topic	IASB	FASB
<b>Unbundling</b>	<p>The IASB decided tentatively that, for recognition and measurement, an insurer should:</p> <ul style="list-style-type: none"> <li>▶ Unbundle a component of an insurance contract if it is not interdependent with other components of that contract</li> <li>▶ Not unbundle a component that is interdependent</li> </ul>	<p>The FASB decided tentatively that if unbundling is not required for recognition and measurement, it should not be a permitted option. The FASB asked staff to clarify further how unbundling for recognition and measurement relates to:</p> <ul style="list-style-type: none"> <li>▶ The definition of an insurance contract and the scope of the proposed standard</li> <li>▶ The presentation models for the performance statement</li> <li>▶ Bifurcation of embedded derivatives</li> </ul>
<b>Presentation of the performance statement</b>	The Boards tentatively rejected a model that recognises revenue on the basis of written premiums (rather than recognising revenue as the insurer performs under the contract).	
<b>Other Comprehensive Income (OCI)</b>	<p>The IASB decided tentatively:</p> <ul style="list-style-type: none"> <li>▶ Not to change the accounting for an insurer's assets</li> <li>▶ Not to permit or require the use of OCI for insurance contracts</li> </ul>	The FASB will discuss OCI at a future meeting.

Source: IASB Staff Paper 14, Ernst & Young.

## Universal life insurance and other account driven contracts

The Staff will present two papers to the February joint meeting where they will seek the Boards' views on an appropriate measurement basis for account driven insurance contracts.

The IASB's discussion paper *Preliminary Views on Insurance Contracts* identified three variations on account-driven contracts:

- ▶ **Universal life** in which the insurer has discretion to change the amounts of credits and charges and the policyholder has the discretion to vary the amount of premium paid and life insurance coverage.
- ▶ **Index-linked** contracts, in which the amount of the interest credit is based on a bond or equity index. In many cases, the insurer is required to pay a minimum interest rate, and the amount to which this minimum applies resets periodically.
- ▶ **Unit-linked or variable contracts**, in which the policyholder's account is invested in a separate managed fund and isolated from the general creditors of the insurance company. Unit-linked and variable contracts present the issue of whether the managed fund is an asset of the insurance company, and the balance a liability, or whether the fund is like a mutual fund or bank trust account.

Earlier discussions by the Boards have focused on premium driven contracts, where the value of a policyholder account is based on the amount of premium paid. The Boards have tentatively decided that the measurement of premium driven contracts should be based on the four building block approach. The Staff will ask the Boards to consider whether they agree with their recommendation that the

same measurement model be applied to both premium driven and account driven contracts or whether an alternative measurement model is more appropriate for account driven contracts.

Some commentators have argued that account driven contracts should be accounted for based on the individual charges and credits inherent in the contract. The Staff will argue that those various charges and credits are important because of the way they change the risk profile, and thus the value, of a book of account driven contracts. An individual element in an account driven contract, though, is not necessarily the same as that element as a standalone contract. The Staff are persuaded by those observers who note that the combination of elements in the contract do not behave the same as a synthetic combination of independent items. In their view, that argues for application of the building block approach to the entire contract.

Unit-linked contracts present an additional complication over and above the measurement approach to be adopted. That is, whether the funds into which premiums are deposited represent an asset and corresponding liability of the insurance entity. On this issue, the Staff will recommend:

- ▶ Assets and related liabilities associated with unit linked contracts, including those defined as separate accounts, should be reported as the insurer's assets and liabilities in the statement of financial position.
- ▶ Issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts) are addressed in the consolidations project rather than in the insurance contracts project.

## Unbundling

The IASB has previously decided that, for recognition and measurement, an insurer should separately account for (unbundle) a component of an insurance contract if it is not interdependent with other components of that contract. However, some Board members at the joint meeting on 5 January wanted to look at the proposals for unbundling in the context of the overall model proposed for insurance contracts. A paper on the definition and scope of an insurance contract will be presented at the March joint meeting. In addition, when the issue was previously discussed by the Boards, members have asked for clarity about the meaning of interdependency. The Staff will present a paper where they will propose that an insurer should unbundle an insurance contract on the basis of an interdependency trigger. Interdependence is the key factor that creates 'overlap' of components of an insurance contract. The interdependence test would be applied:

- ▶ In two directions, i.e., where one component depends on the other, the opposite must also hold true. Thus, if component A is dependent on component B, but component B is not dependent on component A, component B would be unbundled.
- ▶ To the individual components of the contract. If there is interdependency between some components but not between others, those components that are not subject to interdependency should be unbundled.

The Staff will also recommend that, where unbundling is not required based on the above tests, it would not be available as an accounting choice.

The Staff will also discuss a paper on an alternative view on unbundling at their joint meeting.

## Field test results

The Staff will present a paper outlining the results from the first round of field tests, including an analysis from the 16 respondents. Responses highlight that, in jurisdictions where statutory or regulatory requirements are broadly similar to the Boards' tentative decisions on measurement, participants were more comfortable with the proposals. Some life insurers already use projected future cash flow measurement methods to prepare:

- ▶ Their financial statements (Australian and Canadian insurers)
- ▶ Supplementary information for capital market users (embedded value (EV) approaches)
- ▶ Internal management information on economic value or for risk management and capital allocation

Participants highlighted two areas where they thought that recent tentative decisions made by the Boards would have a significant financial impact on their business:

- ▶ Acquisition costs (day one losses through immediate expensing)
- ▶ Discount rate (day one losses for some types of contract through the use of a risk-free rate)

## Presentation of the performance statement

The Staff will present a paper on various options for presenting the performance statement (the statement of comprehensive income) at the February meeting. The Staff will argue that the measurement approach should drive the presentation model for the performance statement. As a consequence the Boards will be asked to recommend that, as a minimum, the following should be presented on the face of the performance statement:

- ▶ The release of the expected margin during the period flowing from the measurement model, showing the release of the risk adjustment separately from the release of the residual margin either on the face of the income statement or in the notes
- ▶ The difference between the expected and the actual cash flows
- ▶ Changes in estimates (remeasurements)
- ▶ Results from investments, showing separately:
  - ▶ interest income
  - ▶ interest on the insurance liability

At the 5 January joint meeting, the Boards discussed presentation models for insurance contracts. The Boards tentatively decided at that meeting that the presentation model should not report revenues on the basis of payments received from the policyholder (written premium). The Staff will discuss a number of presentation options which reflect this principle at the February meeting.

## Timetable for Boards discussion

An insurance Exposure Draft is expected to be published in June 2010. The majority of open issues will be discussed by the Boards at their joint meeting in March, with the April meeting reserved for any sweep issues.

## Follow the discussion

Accounting for insurance contracts will be discussed by the IASB and FASB at their joint meeting on Thursday 18 February between 16:00 and 19:00 GMT. You can register to follow the discussion at [www.iasb.org](http://www.iasb.org).

We welcome your feedback on *Insurance Accounting Alert*. Please get in touch with your local Ernst & Young insurance contact with any enquiries.

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