

IASB Exposure Draft on *Insurance Contracts* – the First Building Block: Probability Weighted Cash Flows

Abstract

In July 2010, the IASB released its long awaited exposure draft on accounting for insurance contracts. The proposed approach differs from current U.S. GAAP practices, and is based on three “building blocks”:

- Probability weighted estimates of future cash flows
- Discounted cash flow estimates
- Risk adjustment and residual margin for uncertainty and future profits

In the February edition of *Insurance Accounting Perspectives*, we discussed the debate over the concepts of risk adjustment and residual profit margins. In this edition, we tackle the complexities of another building block, probability weighted cash flows.

This building block is defined as a current, unbiased and probability weighted estimate of the projected future cash flows expected to arise as the insurer fulfills its obligation in accordance with the terms of the insurance contract (*current fulfillment value*). The process to estimate such future cash flows should be made from the insurer’s perspective on an expected value basis, covering all relevant cash flows including premiums, expenses, claims/benefits payments, incremental acquisition costs and policyholder dividends.

The IASB Exposure Draft *Insurance Contracts* and the FASB discussion paper *Preliminary Views on Insurance Contracts* base the measurement of insurance contracts on the following building blocks:

IASB	FASB
1. Expected value of future cash flows	1. Expected value of future cash flows
2. Time Value of money (discount rate)	2. Time Value of money (discount rate)
3. Risk Adjustment	3. Composite Margin
4. Residual Margin	

Source: IASB/FASB Meeting, Week commencing 17 January 2011, Staff Paper

More specifically, the cash flow estimates for a portfolio of insurance contracts should include **incremental** cash inflows and outflows arising from that portfolio, and must be:

- **Explicit** – cash flows must be estimated separately before considering risk adjustments and before discounting those incremental cash flows
- **Unbiased** – assumptions should incorporate all available information about the amount, timing and uncertainty of cash flows expected as the insurer endeavors to fulfill the terms of the insurance contract
- **Current** – reflecting the perspective of the entity as of the reporting date, but also consistent with observable markets, where applicable, as of that reporting date

In our view, some of the most important aspects to the proposed **cash flow-based methodology** are as follows:

1. Acquisition expenses - only directly attributable and incremental acquisition costs are included in the cash flow estimates. Incremental acquisition costs are defined in the exposure draft as the “costs of selling, underwriting and initiating an insurance contract... that would have not been incurred if the insurer had not issued that particular contract, but no other direct or indirect costs.” Such incremental costs would be determined for individual contracts, not for a portfolio of similar contracts. This proposed language points to a much more limited definition when compared with the deferred acquisition cost (DAC) definition (under current U.S. GAAP).

2. Contract boundary - to identify future cash flows expected to arise as the insurer fulfills the obligation, it is necessary to determine whether future premiums and the resulting benefits and claims arise from existing contracts and which therefore would be included in the liability measurement, or from future contracts which would not be included in the measurement. To achieve this distinction, the exposure draft proposes that the boundary of an insurance contract would be 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, as a result, can set a price that fully reflects that risk.” By defining the contract boundary the IASB is recognizing that there are cash flow timing differences between the unconditional and immediate obligation to pay claims, and the rights to receive future premiums.

3. Probability weighting – requires the determination of various scenarios and an estimate of the probability associated with each scenario. The exposure draft does not prescribe any specific method; however, stochastic modeling is one approach to consider for estimating probability weighted cash flows. Stochastic modeling is not typically used in an insurance accounting environment; however, it is frequently used by insurance companies for enterprise risk management, such as liquidity stress testing scenarios, and investment portfolio management.

4. “Own credit standing” – In the 2007 discussion paper, the IASB had endorsed the controversial notion of using a company’s own credit standing to establish liabilities, i.e., if a company was less likely to be able to pay its claim obligations, its reserves would be reduced. However, under the proposed standard, the present value of the fulfillment cash flows will not reflect the risk of non-performance by the insurer, either at initial recognition or subsequently. This change eliminated one of the most controversial aspects of the proposed standard.

5. Reinsurance - the measurement of reinsurance contracts is performed by following the same principles used for direct insurance contracts. One key difference, however, is that the risk of non-performance by the reinsurer shall be considered by the ceding company when determining the expected value of the cedant’s future fulfillment cash flows. The ceding company must reduce the value of its reinsurance asset based on its estimate of expected losses.

The International Accounting Standards Board (IASB) issued an Exposure Draft (ED) on 30 July 2010 which, if adopted, will replace IFRS 4 Insurance Contracts (IFRS 4). The ED seeks to establish a single consistent recognition and measurement model, with complementary presentation and disclosure requirements aimed at enhancing transparency, for all insurance contracts issued by entities reporting under International Financial reporting Standards.

While comments on this exposure draft are not due until November 30, 2010, the RMA © team has already provided initial comments In the February 2011 edition of **Insurance Accounting Perspectives**. Among the concerns cited is the proposed premium allocation approach towards short duration contracts. RMA © team and other interested parties maintain the approach is overly complex and unsuitable for most property-casualty contracts, having been developed with more of a life insurance orientation. Given that these industry concerns date back to the 2010 release of the IFRS 4 Phase II Discussion Paper, and that the FASB has not yet taken a insurance companies position, we believe there will be much more discussion and debate before this portion of the standard is finalized.

Appendices:

www.rmadviser.com/Insurance Accounting Perspectives/A1. Measurement Model.pdf

www.rmadviser.com/Insurance Accounting Perspectives/A2. Subsequent Measurements.pdf

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