

IASB Exposure Draft - *Accounting for insurance contracts* : Worldwide Standard

Abstract

On 30 July 2010, the International Accounting Standards Board (IASB) published an exposure draft of the new accounting standard governing accounting for insurance contracts, as currently covered by IFRS4. The full exposure draft can be found at <http://www.ifrs.org/>.

Link to IASB's financial statement project

The IASB and FASB are busy with the financial statement project. Its aim is to publish a standard (in 2011) for setting up presenting financial statements. This project includes the financial statements of all sorts of undertaking – not only insurers.

The IASB's long-awaited *Insurance Contracts Exposure Draft* represents a significant step forward in financial reporting for insurers. However, there are a number of areas where we believe changes are needed.

The new standard is intended to:

- *establish a comprehensive framework requiring insurers to provide users of the financial statements with information that is relevant to 'economic decision-making';*
- *eliminate inconsistencies and weaknesses in existing practice by replacing IFRS4, Insurance Contracts; and*
- *provide comparability across entities, jurisdictions and capital markets.*

In order that a single, worldwide standard be developed, the IASB has undertaken this project in close consultation with US Financial Accounting Standards Board (FASB), although three years of consultation have ultimately been unsuccessful, with different conclusions being reached in key areas.

The new standard covers only insurance and reinsurance (both issued and held) contracts into which the insurer has entered. The standard does not cover accounting for financial assets and liabilities. The main **changes cover the following areas.**

1. Measurement

An insurer shall be required to measure an insurance contract as:

- the expected **present value of the future cash flows** arising under the contract as the insurer fulfils its obligations. This estimate should be adjusted for the time value of money, calculated using an appropriate discount rate (i.e. one that will allow for the characteristics of the cash flows for that business). Cash flow assumptions should be re-assessed at each reporting date;
- a **risk margin**, which should reflect the amount that an insurer would pay to be relieved of the risks. The risk margin should be assessed for each portfolio of contracts and should reflect the uncertainties about the amount and timing of the expected cash flows; and
- a **residual margin**, which is designed to eliminate any gains at the inception of the contract. The residual margin should be calculated for each portfolio of insurance contracts and within each portfolio, by date of inception and period of coverage. To ensure that any losses are recognised at inception, the residual margin is subject to a minimum amount of zero. This residual margin is to be released throughout the coverage period of the contract, as income through the profit and loss account, in a way that reflects the exposure of providing the insurance.

The basis of valuation differs from that required under Solvency II, under which no residual margin is to be calculated. The calculation of the risk margin also differs from that required under Solvency II, with the exposure draft requiring no cost of capital calculation.

2. Short-duration contracts

For contracts that are for one year or less and where the insurance contract contains no embedded options or derivatives, the insurer should:

- measure its pre-claims liability by allocating premiums over the coverage period; and
- measure its claims liability at the present value of the fulfilment cash flows.

The insurer shall release the pre-claims obligation over the period of coverage in a systematic way that best reflects the exposure to the insurer of providing the insurance cover, as follows:

- on the basis of the passage of time; or
- where that pattern differs significantly from the passage of time- on the basis of the expected timing of the incurred claims.

Insurers writing short duration contracts, whilst not applying the residual margin, will be

required to conduct a review for onerous contracts, where the expected cash outflows exceed the pre-claims obligation. Where an onerous contract is recognised, the insurer shall recognise an additional liability and expense accordingly. This additional liability should be reviewed at the end of each accounting period and reversed to the extent that the contract is no longer onerous.

3. Presentation of financial information

Due to the fundamental changes in the recording of insurance contracts, there will be significant changes to the presentation in financial statements. The balance sheet will remain largely unaltered however, the statement of comprehensive income will be markedly different in terms of presentation.

The exposure draft states that at a minimum, the statement of comprehensive income shall include line items for:

- *underwriting margin, separately identifying in the statement or the notes the change in the risk adjustment and the release of the residual margin; and*
- *gains and losses at initial recognition.*

The statement of comprehensive income shall not include premiums, claims expenses, claims handling expenses, incremental acquisition costs and other expenses included in the measurement of insurance contracts.

For short duration contracts, the insurer will additionally have to include in its statement of comprehensive income:

- *the underwriting margin, split down in either the primary statement or the notes into premium revenue, determined as the gross release of the pre-claims obligation;*
- *claims incurred;*
- *expenses incurred;*
- *amortisation of incremental acquisition costs included in the pre-claims obligation.*

Anybody wishing to respond to the IASB must submit a written response by 30 November 2010. The timescale for implementation has not been set out in the exposure draft, however it is anticipated that implementation will be for years ending 31 December 2012.

4. The Future Convergence

Convergence is coming. While there is still some time to wait before it will be realized, the needs of stakeholders for current and transparent understanding of insurer's business is leading to a common valuation framework. Subtle differences in methodologies are likely to remain that will affect how the business is managed, and they need to be understood by management and users of the information.

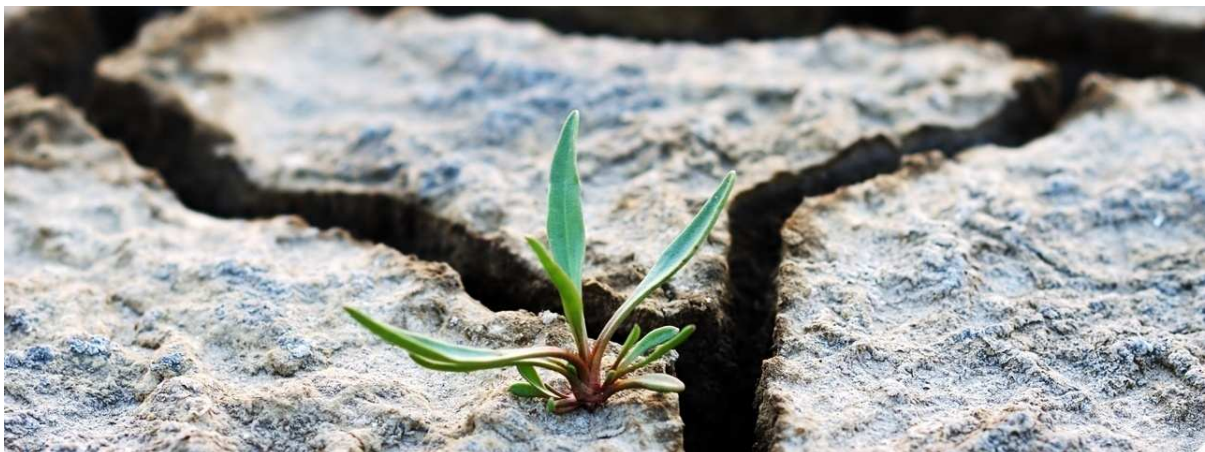
The details off what IFRS 4 Phase II will look like are not yet available, and profound discussions will be needed to solve at least the current issues of

- risk margins,
- discount rates,
- day one profits,
- performance measurement , and
- product boundaries.

However, there are clear benefits to convergence with the valuation methods being advanced for MCEV and Solvency II.

The publication of the Exposure Draft on 30 July 2010 is a major milestone in the sccond phase of the insurance contracts project.

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