



IASB staff update measurement candidates and timetable for new insurance standard and recommend field testing

Overview

On 18 June 2009, the IASB will meet to continue their debate on accounting for insurance contracts. In July 2009, the IASB and FASB (the Boards) will be asked to choose a measurement approach for insurance contracts. In anticipation of those decisions, the June meeting will focus on the re-evaluation of candidate measurement approaches discussed to date.

A summary of topics discussed, and tentative decisions made, by the Boards to date with respect to potential candidate measurement approaches is set out in the table overleaf.

The story so far...

The table below summarises IASB and FASB discussions to date:

Summary of tentative decisions

Topic	IASB	FASB
Features of a measurement approach for insurance contract liabilities	<p>A measurement approach for insurance contracts conceptually should:</p> <ul style="list-style-type: none"> ▶ use estimates of financial market variables that are as consistent as possible with observable market prices ▶ use explicit current estimates of the expected cash flows ▶ reflect the time value of money ▶ include an explicit margin 	<ul style="list-style-type: none"> ▶ A measurement of the fulfilment value of an insurance contract should use expected cash flows rather than a best estimate of cash flows. Those expected cash flows should be updated each period ▶ The measurement of cash flows should 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 ▶ The FASB will discuss time value of money and margins at a future meeting
Measurement objective	<ul style="list-style-type: none"> ▶ The IASB discussed whether a measurement approach for insurance contracts should be based on an exit notion or a fulfilment notion. Views diverged and no clear consensus emerged 	<ul style="list-style-type: none"> ▶ The FASB agreed to explore an approach where an insurance contract is measured at a current fulfilment value rather than fair value as defined in FASB Statement No. 157, Fair Value Measurements (an exit value). The fulfilment value is currently not a defined measurement approach but would be based on entity-specific inputs that generally would not require consideration of market participant views
Measurement of the margin at inception	<ul style="list-style-type: none"> ▶ The margin at inception should be measured by reference to the premium and therefore no day one gains should be recognised in profit or loss (except for the part of the premium that covers acquisition costs, as discussed in more detail below) ▶ The Board decided tentatively that if the initial measurement of an insurance contract results in a day-one loss, the insurer should recognise that day-one loss in profit or loss 	<ul style="list-style-type: none"> ▶ In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit ▶ The FASB will discuss this issue (day-one losses) at a future meeting
Margins	<ul style="list-style-type: none"> ▶ The IASB discussed some topics on margins. Views diverged and no clear consensus emerged. The Board will return to the topic of margins at a future meeting. 	<ul style="list-style-type: none"> ▶ The FASB discussed several aspects of the accounting for risk margins. The FASB did not reach any decisions on these issues
Candidate measurement approaches	<ul style="list-style-type: none"> ▶ 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. The candidates to be considered at a future meeting include an unearned premium approach for short-duration pre-claims liabilities ▶ The IASB discussed whether to add to the list of measurement candidates presented by the staff and asked the staff to analyse further whether to apply measurement approaches used in other existing and future standards, notably those on revenue recognition, financial instruments and non-financial liabilities 	<ul style="list-style-type: none"> ▶ The FASB will consider at a future meeting whether an approach for measuring insurance contracts would include using future cash flows with no margins and no discounting in certain instances

Topic	IASB	FASB
Acquisition costs	<ul style="list-style-type: none"> ▶ The Board discussed an example in which two insurers issue identical insurance contracts but incurred different acquisition costs and, as a result, charged premiums that differ by the same amount. The Board decided tentatively that those contracts should have the same initial measurement. ▶ As a follow up, the Board decided tentatively that at inception an insurer should recognise as revenue the part of the premium that covers acquisition costs. For this purpose, acquisition costs should be limited to the incremental costs of issuing (i.e. selling, underwriting and initiating) an insurance contract and should not include other direct costs. Incremental costs are those costs that the insurer would not have incurred if it had not issued those contracts 	<ul style="list-style-type: none"> ▶ An entity: <ul style="list-style-type: none"> ▶ Should expense all acquisition costs when incurred. ▶ Should not recognise any revenue (or income) to offset those costs incurred.
Policyholder behaviour and contract boundaries	<ul style="list-style-type: none"> ▶ The measurement should include the expected (ie probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, eg benefits and claims) resulting from those contracts, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts. ▶ To identify the boundary between existing contracts and new contracts, the starting point would be to consider whether the insurer can cancel the contract or change the pricing or other terms. The staff will develop more specific proposals for identifying the boundary. 	<ul style="list-style-type: none"> ▶ The FASB will discuss this issue at a future meeting.

Source: IASB Staff Agenda Paper 16, Ernst & Young

At the June meeting, the Staff will recommend to the Boards that:

- ▶ A measurement approach based on the discussions in the project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (the updated IAS 37 model) should be added to the list of candidates
- ▶ A current fulfilment value that includes a margin for the cost of bearing risk and a residual margin (previously Candidate 3) is no longer needed
- ▶ Current exit price (previously Candidate 1) should be removed from the list of candidate measurement approaches due to a preference for an approach based on the updated IAS 37 model.

Discussion of each of the recommendations above is presented in the sections below. Definitions of each candidate measurement approach discussed to date and the status of each is presented in Appendix A.

At the meeting, the Staff will also present recommendations for field testing the proposals as well as an updated timetable to complete the discussions. An Exposure Draft of a new standard is planned for release in April 2010, and a final standard by July 2011

New measurement candidate: updated IAS 37 model

Based on the IASB's tentative decisions in its IAS 37 project in April 2009, the Staff suggest that the updated IAS 37 model discussed in that project be considered as a potential basis for developing a measurement approach for insurance contracts. The Staff stress that the aim is not to account for insurance contracts under IAS 37, but to use that model in the insurance contracts project. The objective of such a model would be to measure the amount that an entity would rationally pay at the end of the reporting period to be relieved of its present obligation. This would, depending on the circumstances, either reflect the amount the insurer would have to pay to transfer the obligation, or the burden of having to fulfil it over time. This differs from current exit value as described in the Discussion Paper *Preliminary Views on Insurance Contracts* (the DP), which focused on measuring the amount a third party would demand for taking on the obligation.

The Staff believe that the IAS 37 model:

- ▶ Meets the requirements set by the tentative decisions of the Boards to date (refer to Appendix A)
- ▶ Presents a candidate with a new objective (transfer price of the holder), which provides a clear principle to help determine which cash flows and margins should be included
- ▶ Provides a degree of consistency between measurement of uncertain liabilities (IAS 37 liabilities) and insurance contracts.

Obligations from contracts with customers generally are not in the scope of IAS 37. However, as noted, the Staff does not propose accounting for insurance contracts under IAS 37, but instead believes that the updated IAS 37 model can be used as a basis for developing a measurement approach for insurance contracts. The fact that IAS 37 does not cover contracts with customers will necessitate additional adjustments to the updated IAS 37 model when applying it to insurance contracts, including, for example, exclusion of day one gains. These will be considered further at future meetings.

Many respondents to the DP objected to the model presented in that paper (current exit value) because it would require consideration of the estimates of a hypothetical market participant despite the fact that insurers generally do not transfer their liabilities and despite the lack of an active secondary market. While an active market may not exist to measure the amount that an insurer would pay to be relieved of a liability either, the updated IAS 37 model clarifies that, in such circumstances, the insurer can estimate that amount by considering the burden to the insurer of having to fulfil the obligation over time (i.e., reverting to a fulfilment notion).

A summary of the key attributes of a candidate measurement approach based on the updated IAS 37 model is presented in the table below

Attribute	Approach
Definition	The amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation, plus a residual margin based on the day one difference
Building blocks	<ul style="list-style-type: none"> ▶ Current estimate of the expected (ie probability weighted) present value of future cash flows ▶ Discounting for time value of money ▶ Inclusion of explicit margins
Inputs for which observable market information is available	Consistent with observed market prices
Other inputs	The entity's estimate of the cash flows it would incur in fulfilling the liability
Portfolio-specific cash flows	Included
Entity-specific cash flows	Included
Subsequent measurement	Current estimates for all variables
Changes in estimates of cashflows	Effect included in profit or loss
Risk margin	The amount the entity would pay to be relieved of risk
Service margin	The amount required by a contractor for other services
Residual margin (day one difference)	No profit at inception. Residual margin recognised as a separate item within insurance liabilities
Acquisition costs	Expensed when incurred
Part of premium expected to recover incremental acquisition costs	IASB: recognised as revenue on day one/ FASB: included in residual margin
Own credit risk	To be discussed

Source: IASB Staff Agenda Paper 10D, Ernst & Young

Removal of current fulfilment value with a specific risk margin

The Staff believe that the current fulfilment value candidate that includes a separate risk margin for the cost of bearing risk (previously referred to as Candidate 3) is so similar in many respects to the candidate based on the updated IAS 37 model described above, that it is not worth pursuing both of these candidates. The Staff therefore recommend that the Boards remove this candidate from the list of potential measurement candidates.

The Staff also believe that it is worthwhile to retain the current fulfilment value candidate that includes a composite margin (previously referred to as Candidate 4). Supporters of this

candidate approach do not regard a split between a risk margin and other components of the margin as reliable or useful. This is a key distinction between this and the other measurement candidates.

Removal of current exit price

In February 2009, the FASB decided not to explore the current exit price approach for insurance contracts (previously referred to as Candidate 1). Therefore, the Staff recommendation to remove the current exit price approach from consideration relates solely to the IASB.

The Staff state that insurance contracts generally cannot or will not be transferred and, as such, there is no active secondary market for insurance contracts. A current exit price approach considers the perspective of market participants, while the updated IAS 37 model would use the perspective of the insurer in determining the value of insurance liabilities. The Staff argue that, if uncertain liabilities are accounted for under IAS 37 using the perspective of the entity rather than a hypothetical market participant, one would expect it to be used also for other uncertain liabilities, including insurance contracts.

The Staff view the updated IAS 37 model as preferable to current exit price. In addition, they note that the Boards rejected a current (exit) price approach as a measurement candidate for contracts with customers in the Discussion Paper on revenue. The Staff therefore recommend the removal of current exit price from the list of candidate measurement approaches.

Field testing

In a separate paper for the June 2009 meeting, the Staff will present initial proposals for field testing. The Staff aim to use field testing to help the Boards to understand: a) the current basis of accounting; b) incremental costs and benefits of moving to a new approach; c) obstacles affecting application of the proposed approach; and d) whether the proposed approach is operational for an entity with a reasonable level of knowledge and sophistication using information that is currently available or that can be created. The Staff recommend:

- ▶ Targeted testing of specific topics at various times, instead of a comprehensive test of a complete set of accounting requirements
- ▶ Testing starting shortly after the Boards have made a tentative decision on measurement approach (currently scheduled for July 2009)
- ▶ Testing that asks participants to answer questions on specific topics such as estimation of cash flows, determination of discount rates, determination of risk margins, treatment of acquisition costs, features of participation contracts, effects of policyholder behaviour and others
- ▶ A test group of 15 insurers selected based on: a) geographic spread; b) diversity of line of business; c) some mutual companies; d) size; and e) willingness and ability to participate.
- ▶ Invitation to the user community to participate in field testing

Updated timetable and next steps

The Staff will present an updated project timetable for the Board discussions and Working Group meetings - aiming for an Exposure Draft in April 2010. The updated timetable sets out the following timeline for key discussions.

Meeting date	Key discussion topics
July 2009	<ul style="list-style-type: none"> ▶ Conclusion on measurement approach ▶ Use of unearned premium for short-duration contracts
September 2009	<ul style="list-style-type: none"> ▶ Other issues, including use of OCI and non-performance risk ▶ Discount rates
October 2009	<ul style="list-style-type: none"> ▶ Policy holder participation, classification ▶ Participating, unit-linked and index-linked insurance contracts, investment contracts and universal life contracts
November 2009	<ul style="list-style-type: none"> ▶ Presentation and disclosure ▶ Other issues, including guarantee fund assessments, tax, salvage and subrogation
December 2009	<ul style="list-style-type: none"> ▶ Policyholder accounting ▶ Policyholder participation, measurement
January 2010	<ul style="list-style-type: none"> ▶ Minor issues, including business combinations, taxes, interim reporting, transition and amendments ▶ Policyholder accounting
April 2010	Publication of Exposure Draft
August 2010	Comments due
July 2011	Publication of final standard

Source: IASB Staff Agenda Paper 10F, Ernst & Young

Follow the debate

The IASB will discuss the insurance project (and the Agenda Papers referred to in this summary) on 18 June 2009 from 2 PM to 3:15 PM UK time. Observers can register to view the meeting via webcast on the IASB website (www.iasb.org).

Appendix A

The table below presents the definition and status of the tentative candidate measurement approaches discussed by the Boards to date assuming that the Boards concur with recommendations of the Staff.

Candidate	Definition	Status
Current Exit Value (Candidate 1)	The amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Plus a "residual margin" based on the day one difference.	Removed from the listing of potential measurement candidates due to similarity to the updated IAS 37 model and the Staff's preference for consideration of rights and obligations from the insurer's point of view instead of a hypothetical market participant
Measurement approach based on updated IAS 37 model (New Candidate)	The amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation. Plus a "residual margin" based on the day one difference.	Added to the listing of potential measurement candidates at the June 2009 meeting
Current fulfillment value with a risk margin and service margin (Candidate 2)	The expected present value of the cost of fulfilling the obligation to the policyholder over time.	Removed from the listing of potential measurement candidates at the April 2009 meeting following the Boards conclusion that day one gains should not be allowed
Current fulfillment value with a risk margin and residual margin (Candidate 3)	The expected present value of the cost of fulfilling the obligation to the policyholder over time, including the cost of bearing risk. Plus a "residual margin" based on the day one difference.	Removed from the listing of potential measurement candidates due to similarity to the updated IAS 37 model
Current fulfillment value with a composite margin (Candidate 4)	The expected present value of the cost of fulfilling the obligation to the policyholder over time, excluding the cost of bearing risk. Plus a "composite margin" based on the day one difference.	Remains included within the listing of potential measurement candidates
Unearned premium (Candidate 5)	The part of the premiums for the unexpired part of the insurer's contractual obligation, subject to a liability adequacy test.	Remains included within the listing of potential measurement candidates, but will not be discussed in detail until the July 2009 meeting

Source: Ernst & Young

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