



IFRS – Insurance Newsletter

February 2010, **Issue 4**

This IFRS Insurance Newsletter highlights key developments relating to the joint International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) Insurance Contracts project, including the results of recent IASB and FASB discussions regarding reinsurance, policyholder accounting, unbundling, presentation of the statement of comprehensive income and unit-linked and variable contracts. Additionally, this newsletter provides the current status of the project and anticipated timeline for completion.

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KPMG's monthly update on the joint IASB/FASB insurance project

Overview

The IASB and FASB (the Boards) met twice this month to continue discussions on key issues regarding presentation of the statement of comprehensive income, unbundling, embedded derivatives, policyholder accounting, reinsurance and unit-linked and variable contracts. Some of these topics proved easier to tackle by the Boards than others, resulting in overall progress slower than anticipated.

As a follow up to the January meetings (see the IFRS – Insurance Newsletter – Issue 3), the IASB and FASB staff (the staff) added unbundling, embedded derivatives and the presentation of the statement of comprehensive income to the agenda this month for discussion by the Boards. In January, the majority of the IASB members voted in favour of the previous staff recommendation to require unbundling only when components of the contract are *not* interdependent and to prohibit unbundling when components are interdependent, with further clarification requested around the notion of interdependency. In contrast, the FASB members did not support the recommendation and asked the staff to clarify further how unbundling for recognition and measurement relates to the definition of an insurance contract and the scope of the proposed standard, the presentation models of the statement of comprehensive

income and bifurcation of embedded derivatives. In this month's meetings the Boards revisited these issues with limited resolution. Although the Boards indicated some support for developing a principle for unbundling and embedded derivatives centered on the notion of "interdependency", further questions remain on the meaning of interdependency and how this notion will be applied to different insurance products. The Boards were divided in their preferences on the proposed presentation options and were unable to complete their discussions on unit-linked and variable contracts. As a result, limited decisions were made regarding these topics during February.

The Boards made some progress in the area of policyholder accounting and reinsurance. They decided tentatively to exclude policyholder accounting from the Exposure Draft except as it relates to the accounting for participating contracts and acquisition costs (to be discussed in March) and to apply the proposed building block measurement approach for insurance contracts to assumed and ceded reinsurance contracts.

The Exposure Draft is expected in May 2010 based on the published timeline. The Boards did not discuss the timeline and it is currently unclear if the Exposure Draft will be delayed further.

Recent Meetings

10 February 2010 Joint Meeting Reinsurance

An insurance contract involves purchase by a policyholder (the insured) of protection against a potential insurable loss from an insurer. Reinsurance is a transaction in which a reinsurer (the assuming entity), for consideration (premium), assumes all or part of a risk undertaken originally by another insurer (the ceding entity or cedant). However, the legal rights of the insured typically are not affected

by the reinsurance transaction, and the entity issuing the insurance contract remains liable to the insured for payment of the policy benefits. The transfer of significant insurance risk from the cedant to the assuming entity must be present in order for the contract to qualify for reinsurance accounting. The Boards plan to discuss significant insurance risk and the definition of insurance contracts, including reinsurance, in March 2010.

The staff recommended that reinsurance contracts use the same recognition and measurement methods used to account for insurance contracts and that the cedant recognises and measures its reinsurance asset (reinsurance recoverable) using the same approach it uses for the reinsured portion of the underlying insurance contract it has issued including:

- the expected present value of the cash flows required to fulfil the reinsured portion of the insurer's obligations;
- the addition of the risk margin (but not the residual margin) included in the measurement of the reinsured portion of the contract liability;
- the addition of a residual margin arising from the reinsurance contract (calibrated to reinsurance premium); and
- a reduction for the impact of possible impairment and coverage disputes, measured using the building block approach, in other words on an expected value basis, rather than an incurred loss basis.

The Boards agreed unanimously that reinsurers should use the same recognition and measurement principles for the reinsurance contracts that they issue as they use for all other insurance contracts (i.e. the building block approach).

Although the Boards agreed on this fundamental concept for

recognition and measurement, some Board members raised concerns with the proposed measurement approach, including:

- the boundaries of reinsurance contracts if the terms of the reinsurance contracts are not explicit (e.g. annually renewable contracts that do not include any agreement on subsequent year renewals);
- accounting for a *negative* residual margin arising from the reinsurance contract;
- symmetry between a ceding company and an assuming company due to differences in their estimations of expected cash flows, risk margins and the units of account used in measurement;
- whether margins arising from the reinsurance contract may be double counted by the cedant when the margins from underlying contracts are taken into account; and
- whether the risk margin recognised by the cedant in measuring the reinsurance asset should be a symmetric measure to the risk margin recorded on the underlying contract liability.

The Boards asked the staff to perform further analysis on the treatment of impairments and its interaction with the proposed measurement approach and the accounting for negative residual margins. In addition, the Boards asked the staff to prepare accounting examples demonstrating the proposed reinsurance accounting (for both the cedant and the assuming entity) before making final decisions regarding recognition and measurement.

The Boards agreed unanimously that reinsurance balances should not be offset against related direct insurance balances on both the statement of financial position and statement of comprehensive income unless the legal requirements for offsetting are

met; and that reinsurance does not result in derecognition of the related direct insurance liabilities unless the obligation specified in the insurance contract is legally discharged, cancelled or expires.

The staff also proposed that ceding commissions be credited and charged to the statement of comprehensive income by the cedant and reinsurer, respectively, in the same manner as acquisition costs.

The Boards raised concerns on how a reinsurer would determine what element of the reinsurance pricing covered acquisition costs since ceding commission are not always explicit in the contract and may require calculation. It was further noted that ceding commissions can include other elements in addition to acquisition costs. Some members asked for further detail on how a negative ceding commission would be recognised. The Boards agreed that recognising ceding commissions in the statement of comprehensive income by the cedant and reinsurer in the same manner as acquisition costs may be appropriate if the reinsurance contract is proportional. The staff will be performing further analysis to determine if this approach can be applied to non-proportional reinsurance contracts and how to distinguish ceding commissions from other contractual cash flows.

Policyholder Accounting

The Boards had discussed previously whether policyholder accounting (excluding reinsurance) should be included in the scope of the developing Exposure Draft with an acknowledgement that "symmetry" (accounting between the policyholder and the insurer) needed to be reviewed before finalising a decision. Policyholder accounting is not within the scope of the current insurance standard. The staff proposed that accounting by the policyholder (excluding reinsurance)

should *not* be considered further except in relation to discussions on acquisition costs and participating features planned in March 2010. The Boards will consider the need for additional guidance on policyholder accounting for acquisition costs and participating features due to potential mismatches caused in accounting between parties to the insurance contract as a result of tentative decisions made in these areas. Specifically, the Boards previously decided tentatively that acquisition costs should be expensed as incurred and to prohibit the recognition of any revenue to offset these costs, and have diverging views on the treatment of participating features.

The staff presented the following example to illustrate the mismatch that may arise between the insured and the policyholder with respect to acquisition cost accounting:

An insurance contract which an insurer has priced at a single premium of 100 to cover 20 of acquisition costs, 65 of expected cash outflows and a 15 risk adjustment.

Under the current proposed measurement model, the insurer would recognise a liability of 100 (65 expected cash outflows, 15 risk adjustment, 20 residual margin) and an expense of 20 for acquisition costs. If the policyholder made the same assessment of cash flows and risk-adjustment as the insurer, it would recognise an asset of 80 (expected cash inflows and risk adjustment) and a loss of 20, causing some asymmetry in the accounting for the contract.

Some Board members noted that the timing of when to recognise a recovery for a policyholder may still need to be addressed. The majority of Board members agreed with the staff's proposal to exclude policyholder accounting (other than reinsurance)

from the Exposure Draft. The Boards will consider policyholder accounting further in their planned discussions regarding acquisition costs and participating features.

18 February 2010 Joint Meeting Unbundling, Embedded Derivatives and Presentation of the Statement of Comprehensive Income

Subsequent to the joint meetings in January, staff performed additional analysis on the proposals for unbundling, embedded derivatives and the presentation of the statement of comprehensive income with a focus on consistency, since a decision on one topic inevitably affects the decisions on others. Due to the financial statement significance, complexity and pervasiveness of these topics with regard to the entire insurance project, the Boards spent considerable time deliberating these topics.

The staff presented a spectrum of life insurance contracts with varying investment and insurance options including term life, traditional whole life, universal life, index and unit-linked contracts, separate accounts and investment contracts. The staff requested that the Boards consider possible criteria that may differentiate these types of contracts, such as the significance of the investment element to total cash flows, the insurer's discretion, significance of the insurer's remaining mortality/morbidity risk and interdependence of cash flows for purposes of determining a principle for unbundling.

In the staff's papers, two views on unbundling were presented and are outlined below.

Unbundling and Embedded Derivatives

Staff View A (Paper 14C): this approach is summarised as follows:

- 1) Unbundling of a component of a contract for recognition and

measurement should be required if the components of the contract are *not* interdependent. In cases for which unbundling would not be required, it should be prohibited.

- 2) An insurer should apply the notion of interdependence for bifurcation of derivatives embedded in insurance contracts.
- 3) A deposit component is only unbundled for presentation purposes if it is unbundled for recognition and measurement.

The staff paper describes an “interdependence” test to be applied to determine if components are interdependent, which include:

- A two directional consideration, i.e. if component A is dependent on component B, but component B is not dependent on component A, component B should be unbundled.
- An analysis of individual components, i.e. if interdependency exists between some components but not between others, those components not subject to interdependency should be unbundled.

Supporters of this approach believe that many of the investment and insurance components of an insurance contract are interlinked and are too closely related to break out. For example, surrender options when, in many cases, cancelling the deposit component results in the cancellation of the insurance component as well. The value paid out on surrender is the repayment of the deposit component plus compensation for forfeiting the right to future insurance coverage less surrender charges.

In addition to considerations such as cancellation which may create significant challenges in determining boundaries of the components subject to unbundling, the Board members supporting View A had these additional observations:

- When components are interdependent, separate measurement of these components will likely be arbitrary and several assumptions would be required with respect to policyholder behaviour to measure the components.
- The benefit is not substantiated by the effort required since the end result of splitting the components is often to measure the components under the insurance standard and the financial instruments standard, both of which require a value measurement. The argument remains that the “value” measurement model used for insurance contracts has many elements of fair value measurement used for financial instruments although there are clear differences including the inclusion of the entity’s own credit risk.
- Breaking a contract into several components for measurement would not be meaningful for users of the financial statements since investors in an insurance company are more focused on the insurer’s ability to predict cash flows and its sources of earnings.

Finally, many supporters of View A believe that due to the complexities in these products coupled with jurisdictional differences on regulation of insurance products with investment and insurance attributes, a simplified approach for developing a principle is preferred since it would need to be applied universally.

Staff View B (Paper 14D): this approach is summarised as follows:

- 1) Unbundling of a component of an insurance contract for recognition and measurement should be required if the components can function independently from each other. The notion of interdependency should be applied only to situations in which

the components cannot function independently, i.e. only to those situations in which a truly symbiotic relationship is necessary for the individual components to function.

- 2) Embedded derivatives in an insurance host contract should continue to be subject to the existing guidance for derivative instrument accounting and bifurcated when appropriate (for example, when the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract).
- 3) Contracts subject to unbundling should be presented on an unbundled basis in both the statement of financial position and the statement of comprehensive income. The staff also recommended that variable and unit-linked contracts be unbundled and measured accordingly.

Some supporters of this approach (a significant minority of FASB and IASB members) were concerned that some products that exist in the life insurance industry are simply investment contracts with an insurance wrapper, and that investors would want to know who is really bearing the cost of a guarantee (prescribed in many unit-linked contracts, index linked contracts and separate accounts) in a given product. Other supporters of this approach believe that insurers break out investment and insurance components of a contract for management of their business and pricing of the contracts and that financial reporting should follow. Many also felt that the criteria as set forth for interdependency would scope in almost all elements of life insurance contracts and that a refined and more specific definition was needed.

Some supporters of View B believe that unbundling a deposit component was

necessary when a deposit component was clearly identifiable in the insurance contract. These supporters viewed a clear distinction in different types of life insurance products such as term and traditional life, in which the insurer is taking on several risks and resulting assets are pooled in order to cover those risks, as compared to products such as unit-linked contracts or separate accounts in which contract holders have direct participation in the investment earnings of their individual accounts or the asset pool and function more like an investment product for the contract holder.

It was clear many Board members had strong views on when to unbundle and when not to unbundle based on their familiarity with specific types of insurance products in certain countries and also had varying comfort levels in allowing insurers not to unbundle.

The Boards indicated their preference on the following items:

- Unbundling should *not* be required if components are significantly interdependent (with a caveat around what is meant by “significant” and further definition and criteria for the term “interdependent”). A slim majority of IASB members preferred this approach based on the agreed caveats and the FASB agreed to continue exploring the terms significant and interdependent for the purposes of developing a principle for unbundling.
- The Boards also asked the staff to consider whether an account balance functions independently of other components and whether a surrender option would give rise to significant interdependence when refining the approach for unbundling.
- Use of the “interdependence” criteria for bifurcation of embedded derivatives in insurance contracts

with further analysis on the notion of interdependence and the aforementioned caveats.

The Boards will discuss unbundling and embedded derivatives further at a future meeting.

Presentation of the Statement of Comprehensive Income

The staff presented three options for the presentation of the statement of comprehensive income including:

- 1) **Summarised margin:** premiums received are recognised as a deposit receipt and subsequently, as the insurer performs under the contract and is released from risk, the risk adjustment is recognised in the statement of comprehensive income and the residual margin is recognised in the statement of comprehensive income based on the driver selected for releasing the margin. The summarised margin model treats all premiums as deposits and all claims and benefits as repayments to the policyholder; those elements are treated as movements in the insurance liability.
- 2) **Expanded margin:** revenue is recognised as an amount equal to the margin released during the reporting period plus a portion or all of the policyholder claims and benefits, which represents an expansion of the summarised margin approach.
- 3) **Traditional premium allocation (earned premium):** premiums received from the policyholder are recognised as a liability and are released and recognised as revenue as the insurer performs under the contracts. This presentation shows investment income, expenses and an item for the change in insurance liabilities in the statement of comprehensive income.

Another consideration in each of these models is their interaction with the

measurement approach, especially as it relates to unbundling (i.e. presentation of components follows measurement). The staff presented key items that should, at a minimum, be required for disclosure on the face of the statement of comprehensive income, including:

- 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 statement of comprehensive income or in the notes to the financial statements;
- difference between the expected and actual cash flows;
- changes in estimates (e.g. re-measurements); and
- results from investments including interest income and interest on the insurance liability.

The majority of Board members were comfortable with eliminating option 3 (traditional premium allocation approach). A slight majority of the Board members favoured the expanded margin with the remainder, which represented a considerable minority, favouring a summarised margin approach. The Boards decided tentatively that the measurement approach should drive the presentation model for the statement of comprehensive income and encouraged the staff to further develop an expanded margin format for presentation. The Boards also supported the staff’s proposal regarding the items to be disclosed on the face of the statement of comprehensive income.

Variable and Unit-linked Contracts (Including Separate Accounts)

Staff paper 14B presented a discussion on unit-linked or variable insurance and annuity contracts. Unlike traditional life insurance contracts, these have an explicit policy account balance that

is communicated to the policyholder. Premiums are treated as if they were deposits to the account. Interest or investment performance is credited to the account, and charges for insurance, expenses and surrender penalties are debited against the account. The terms of the contracts and local regulation grant limited discretion to both the insurer and the policyholder. In addition, all of the investment performance from the underlying portfolio of assets is passed to the holders of contracts, such that the shareholders and other policyholders neither benefit nor suffer from the investment performance, except if there is a guaranteed minimum return or death benefit.

The staff's paper included the following proposals:

- Assets and 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) should be addressed in the consolidations project rather than in the insurance project.
- Unit-linked contracts should be measured in the same manner as other account driven contracts.
- If an insurer chooses to present the liability as a separate line item, the amount should include all of the insurer's obligations under unit-linked contracts, rather than a balancing figure for the assets.
- Different approaches to accounting for asset-liability measurement mismatches.

The Boards had limited time to discuss this topic and only addressed the first two proposals in the staff's paper.

The majority of Board members indicated a preference for the staff's proposal that assets and liabilities associated with unit-linked contracts, including those defined as separate accounts, be reported as the insurer's assets and liabilities in the statement of financial position.

The majority of Board members indicated a preference for issues involving consolidation of the investment funds associated with unit-linked contracts (including separate accounts) be addressed in the consolidation project rather than the insurance project. The majority of Board members indicated a preference for this approach.

The Boards will most likely continue discussion of this topic in March.

Current Status of the Project

The current status of the insurance contracts project and key decisions made to date are outlined in the table below. Topics labelled "Model of both Boards," indicate that the IASB and FASB have converged in these areas of the project.¹

Topic	IASB	FASB
Building Blocks	<p>"Model of both Boards"</p> <p>The Boards decided tentatively that the measurement for insurance contracts should be based on four building blocks:</p> <ul style="list-style-type: none"> the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation; the time value of money; a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows; and an amount that eliminates any gain at inception of the contract. 	
KPMG Observations:	<ul style="list-style-type: none"> The Boards jointly agreed on the fundamental building blocks of the measurement model, which includes an explicit risk adjustment and an amount to eliminate day one differences. 	
Measurement Approach	<p>"Model of both Boards"</p> <p>The Boards decided tentatively that the measurement approach should portray a current assessment of the insurer's obligation using the building blocks.</p> <p>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. The combination of rights and obligations should be presented on a net basis.</p> <p>The objective for measuring an insurance contract should refer to a value rather than cost notion.</p>	
KPMG Observations:	<ul style="list-style-type: none"> The IAS 37 model approved by the IASB in September 2009 included a service margin which has not been readdressed by the IASB and was not included in the reaffirmation of the model in December 2009. Although the Boards agreed that a net presentation of cash inflows and outflows on an insurance contract was appropriate, many Board members expressed the need for additional disclosure that presents gross results and the building blocks. The Boards have decided tentatively that the measurement objective should express a "value" rather than a "cost" notion. The Boards asked the staff to refine the wording in the measurement objective to express this value notion more clearly. 	
Exclude Discounting and Margins in Some Instances?	<p>The IASB has discussed the arguments for and against selecting an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB has also discussed when to use such an approach for non-life claims liabilities and decided tentatively not to add this to the list of measurement candidates.</p>	<p>The FASB has not yet discussed whether, in certain instances, the measurement of insurance contracts should include future cash flows with no margins and no discounting.</p>
KPMG Observations:	<ul style="list-style-type: none"> Further discussion is expected by the Boards in this area. 	
Non-performance Risk	<p>"Model of both Boards"</p> <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>	

¹ These summaries of the IASB and FASB positions were derived from IASB agenda papers and meetings of the Boards in February 2010.

Topic	IASB	FASB
KPMG Observations:	<ul style="list-style-type: none"> Incorporation of the insurer's own credit risk is a significant distinction between the proposed insurance measurement model and fair value. 	
Use of Inputs	<p>"Model of both Boards"</p> <p>The Boards decided tentatively that measurement should consider all available information that relate to the fulfilment of the contract. All available information includes, but is not limited to, industry data, historical data of the entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract. It should also use current estimates of financial market variables that are as consistent as possible with observable market prices.</p> <p>The discount rate used in measurement of cash flows should be updated each reporting period.</p>	
KPMG Observations:	<ul style="list-style-type: none"> Generally, both Boards support measurement based on experience of and input from the insurer and consistency with market variables when possible. 	
Measurement of Margins at Inception	<p>"Model of both Boards"</p> <p>The margin at inception should be split into 1) risk adjustment and 2) a residual margin measured by reference to the premium so as to eliminate day one gains. If the initial measurement of an insurance contract results in a day one loss, then the insurer should recognise that day one loss in profit and loss.</p>	
KPMG Observations:	<ul style="list-style-type: none"> 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 present value of cash inflows. 	
Risk Adjustment	<p>"Model of both Boards"</p> <p>The Boards decided tentatively that the risk adjustment should be the amount the insurer requires for bearing the uncertainty that arises from having to fulfil the <i>net</i> obligation arising from an insurance contract. The risk adjustment should be re-measured each reporting period.</p>	
KPMG Observations:	<ul style="list-style-type: none"> The Board discussed various sources of information that an insurer might use to estimate this amount. Inputs discussed by the Boards that, when available, may be useful in developing an estimate for the risk adjustment includes the amount that may be charged if the insurer is taking on identical obligations with the same risk exposure or reinsurance prices. It was noted by the Board members that these inputs may include additional amounts not intended to be captured in the risk adjustment and also may not be readily available. The staff will develop additional guidance on how to determine the risk adjustment. Techniques that could be used for determining a risk adjustment were presented for consideration. The approaches introduced were similar to those described in the discussion paper on insurance contracts, including the use of confidence levels, conditional tail expectations, explicit risk adjustments with specified ranges, the cost of capital model and the capital asset pricing model. Some Board members are uncomfortable with the wide range of approaches presented. The staff will develop additional guidance on how to determine the risk adjustment and present this at a future meeting. 	

Topic	IASB	FASB
Discount Rates	<p>The IASB decided tentatively that the discount rate for insurance liabilities conceptually should be adjusted in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on assets backing the liability.</p> <p>The IASB may not be providing any detailed guidance on how to determine the discount rate.</p>	The FASB has not decided yet on this topic and will discuss at a future meeting.
KPMG Observations:	<ul style="list-style-type: none"> Based on the IASB discussion, the discount rate should capture characteristics of the cash flows including currency, duration and illiquidity. 	
Unearned Premium	The IASB decided tentatively that an unearned premium approach would be appropriate for pre-claim liabilities of short duration insurance contracts and to require rather than permit the use of an unearned premium model for those liabilities.	The FASB has not decided yet on this topic and will discuss at a future meeting.
KPMG Observations:	<ul style="list-style-type: none"> The total liability under an unearned premium model would be the sum of the unearned premiums for the coverage period, any liability from the liability adequacy test and an incurred claims liability. The staff is developing broad criteria to distinguish which contracts would be eligible for the unearned premium treatment. While this approach sounds similar to the current model for short-duration contracts in US GAAP, there will likely be some striking differences, most notably the use of a risk adjustment for uncertainty and discounting in the claim liability. There are still many questions to be addressed about the application of this approach. 	
Acquisition Costs	<p>“Model of both Boards”</p> <p>Acquisition costs are expensed when incurred and the insurer should not recognise any revenue (or income) to offset those costs incurred.</p>	
KPMG Observations:	<ul style="list-style-type: none"> The IASB initially leaned toward the concept that premium revenue includes recovery of acquisition costs and that revenue should be recognised to the extent of “incremental” acquisition costs. This also seemed to be the preference indicated by respondents to the field test questionnaires on this subject. The IASB voted (eight to six) and the FASB voted (five to zero) at the October joint meeting that no revenue should be recognised at inception maintaining consistency with the revenue recognition project. 	

Topic	IASB	FASB
Policyholder Behaviour (Contract Boundaries)	<p>“Model of both Boards”</p> <p>The Boards decided tentatively that features which enable policyholders to take actions that change the amount, timing, uncertainty or nature of benefits they will receive (policyholder options), as well as options, forwards, and guarantees related to <i>existing coverage</i>, should be in the measurement of the insurance contract on a “look through” basis using the expected value of future cash flows to the extent those options are in the boundary of the contract.*</p> <p>The staff is currently developing proposals for identifying the “boundary” of the contract. A proposed starting point to identify a boundary between an existing contract and a new contract could be the right for the insurer to cancel the contract or change the pricing or other terms.</p> <p>The Boards decided tentatively to exclude features such as options, forwards and guarantees that do not relate to the existing insurance contract coverage 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> <p>* <i>Based on the Boards request, the staff will perform further research as to whether an option pricing model can be used in measurement.</i></p>	
KPMG Observations:	<ul style="list-style-type: none"> ● The look through approach values the option based on the expected future cash flows related to that option. As discussed in the staff paper, this would also involve valuing all options (and resulting future cash flows that fall within the boundary of the contract). This method would require a probability-based evaluation of future cash flows related to the contract and has features of the lattice approach of valuing options permitted by the Boards for valuing employees’ stock options. ● Some FASB members have expressed concerns about using the look through approach and an explicit risk adjustment. These members prefer a more mathematical model which incorporates an embedded measurement of uncertainty that may be more rigorous and potentially having less bias as compared to the look through approach. ● Further discussion on this topic is expected as the Boards discuss the measurement approaches for the risk adjustment in the proposed measurement model. ● As a consequence of the look through approach for valuing these options, a deposit floor would not apply. ● A key consideration in the measurement model includes the boundary of a contract in terms of renewals (referred to this as “policyholder behaviour”). The Boards decided tentatively to include cash flows for which the amounts or timing depend on whether policyholders exercise options in the contracts. Whether the insurance company can cancel the contract or change the pricing or other terms is the starting point for determining whether cash flows belong to an existing contract or a new contract. 	
Deposit Floor	<p>“Model of both Boards”</p> <p>Applying the tentative decisions made regarding policyholder behaviour, the Boards confirmed tentatively that no deposit floor applies to measurement.</p>	
Policyholder Accounting	<p>“Model of both Boards”</p> <p>The Boards decided tentatively to exclude policyholder accounting (other than reinsurance) from the Exposure Draft except in relation to acquisition costs and participating features.</p>	
KPMG Observations:	<ul style="list-style-type: none"> ● Guidance on reinsurance accounting for both ceding and assuming companies is proposed to be included in the standard. 	

Topic	IASB	FASB
Subsequent Treatment of Residual Margins	<p>“Model of both Boards”</p> <p>The Boards decided tentatively:</p> <ul style="list-style-type: none"> ● To develop specific guidance on how the residual margin should be released to profit or loss over time. ● That the residual margin should not be adjusted in subsequent reporting periods for changes in estimates. 	
KPMG Observations:	<ul style="list-style-type: none"> ● Drivers of the margin as discussed in the staff paper include (1) a release from risk, (2) expected benefit and claim payments, (3) premium receipts, (4) passage of time, (5) funds under management, and (6) a combination of drivers. Many Board members suggested prescribing a more defined driver for certain types of products to better enable financial statement comparability. ● Due to the complexity embedded in the measurement model and varying attributes of different insurance products, some of the Board members suggested one method for recognition, such as straight line over coverage period or as the performance obligation is satisfied to be consistent with the revenue recognition project. 	
Recognition of Insurance Contracts	The IASB has not decided yet on this topic and will discuss again at a future meeting.	The FASB decided tentatively that an entity should recognise an insurance obligation at the earlier of (1) the entity being <i>on risk</i> to provide coverage to the policyholder for insured events and (2) the signing of the insurance contract.
KPMG Observations:	<ul style="list-style-type: none"> ● The IASB discussed recognition of rights and obligations arising under insurance contracts including the treatment of the contract in the period between entering into a contract and the start of coverage period. The Boards plan to return to this topic at a future meeting. ● One significant consideration is to determine when to begin recognising the contract (e.g. the effective date, the date the contract is entered into or signed, or when there is an unconditional offer extended for coverage). ● A key consideration by the FASB is to determine when an insurer is <i>on risk</i> to provide coverage. ● The FASB supported in principle that recognition begins when an insurer enters into an arrangement with the policyholder. 	
Derecognition of Insurance Contracts	The IASB decided tentatively that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principles of IAS 39.	The FASB decided tentatively that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.
KPMG Observations:	<ul style="list-style-type: none"> ● The FASB expressly conveyed that purchasing reinsurance does not trigger derecognition of an insurance liability. 	

Topic	IASB	FASB
Participating Contracts	<p>The IASB decided tentatively to explore a model which includes expected value (i.e. probability-weighted) cash flows in the measurement of an insurance contract. For this purpose, the payments to policyholders arising from participating features in insurance contracts would be cash flows from the contract like any other; those cash flows should be included in the expected present value basis and treated as an insurance liability.</p>	<p>The FASB decided tentatively to explore a model in which the components of a participating contract have to be bifurcated between the guaranteed feature and the participating feature. The participating feature should then be classified as a liability or equity, either as a whole or by splitting it into components. The cash flows from those participating features that result in an insurance liability (if any) will be included on the basis of expected cash flows. Discretionary cash flows will be recognised when the entity has an obligation to make payments.</p>
KPMG Observations:	<ul style="list-style-type: none"> ● Due to the current difference in views, it is possible that both options will be presented in the Exposure Draft. ● One of the challenges in this area, regardless of the view that is adopted, is that there could be varying impacts from the application of the guidance depending on how products are structured and what regulatory constraints exist in different jurisdictions. ● Although there is an aim by some to stay consistent with the principle of bifurcation between liability and equity components in financial instruments (IAS 32 <i>Financial Instruments: Presentation</i>), bifurcation would be difficult to implement in practice for some types of contracts due to the inherent complexity in isolating cash flows from the guaranteed and discretionary features. 	
Use of Other Comprehensive Income	<p>The IASB decided tentatively that the accounting for assets held to back insurance contracts, subject to future consideration of assets held to back unit-linked (variable) and index-linked insurance contracts, should not be changed as part of the insurance contracts project. In addition, the IASB decided tentatively that the use of other comprehensive income for insurance liabilities will not be permitted or required by the standard.</p>	<p>The FASB has not decided yet on this topic and will discuss at a future meeting.</p>
Unbundling	<p>The IASB decided tentatively that, for recognition and measurement, an insurer should:</p> <ul style="list-style-type: none"> ● unbundle a component of an insurance contract if the components of the contract are not interdependent; and ● not unbundle a component that is interdependent. <p>Additional clarification of interdependency has been requested.</p>	<p>In January, 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 and measurement relates to (1) the definition of an insurance contract and the scope of the proposed standard, (2) the presentation of the statement of comprehensive income and (3) bifurcation of embedded derivatives.</p> <p>In February, the FASB deferred reaching a decision until the staff develops further guidance on interdependency.</p>

Topic	IASB	FASB
KPMG Observations:	<ul style="list-style-type: none"> ● Decisions on embedded derivatives and the presentation of the statement of comprehensive income may have an impact on the application of unbundling. ● The driver in determining if components should be unbundled is “interdependency”. ● Interdependency, as currently defined, can be relevant to many options embedded in insurance contracts (as options often relate to the same risk), and consequently the components of the contract might not be unbundled. ● Discussions in February indicate that further analysis is needed of the meaning of “interdependency” for the Boards to make progress on this topic. ● The Boards also asked the staff to consider whether an account balance functions independently of other components and whether a surrender option would give rise to significant interdependence when further refining an approach for unbundling. 	
Presentation of the Statement of Comprehensive Income	<p>“Model of both Boards”</p> <p>The Boards rejected tentatively a model that recognises revenue on the basis of written premiums (rather than recognising revenue as the insurer performs under the contract).</p> <p>The Boards decided tentatively that the measurement approach should drive the presentation model for the statement of comprehensive income. The Boards encouraged the staff to further develop an expanded margin format for presentation.</p>	
KPMG Observations:	<ul style="list-style-type: none"> ● The staff will provide additional detail on how the earned basis will be defined. ● Board members are leaning toward an expanded margin format for presentation. ● Expanded disclosures be included on the face of the statement of comprehensive income including release of the margins, differences between expected and actual cash flows, change in estimates (remeasurements) and results from investments. 	
Reinsurance	<p>“Model of both Boards”</p> <p>The Boards decided tentatively a reinsurer should use the same recognition and measurement approach for a reinsurance contracts it issues as all other insurers use for the insurance contracts they have issued.</p> <p>The Boards supported a recognition and measurement approach for a reinsurance asset (i.e. reinsurance recoverable) using the same recognition and measurement approach used by the cedant for the reinsured portion of the underlying insurance contract it has issued (<i>subject to certain caveats</i>) including a measurement approach which includes:</p> <ul style="list-style-type: none"> ● the expected present value of the cash flows required to fulfil the reinsured portion of the insurer’s obligations; ● the addition of the risk margin (but not the residual margin) included in the measurement of the reinsured portion of the contract liability; ● the addition of the residual margin arising from the reinsurance contract (calibrated to reinsurance premium); and ● a reduction for the impact of possible impairment and coverage disputes, measured using the building-block approach, in other words an expected value basis, rather than an incurred loss basis. <p>The Boards decided tentatively that:</p> <ul style="list-style-type: none"> ● reinsurance balances should not be offset against related direct insurance balances on both the statement of financial position and statement of comprehensive income unless the legal requirements for offsetting are met; ● a cedant should not derecognise the related direct insurance liabilities upon entering into a reinsurance contract unless the obligation specified in the specified insurance contract is (legally) discharged, cancelled or expired; and ● a cedant and the reinsurer should credit and charge, respectively, to the statement of comprehensive income, ceding commissions for <i>proportional</i> reinsurance contracts in a manner consistent with the treatment of acquisition costs. 	

Topic	IASB	FASB
KPMG Observations:	<ul style="list-style-type: none"> ● Although the Boards were supportive of the proposed building block measurement and recognition approach, they asked the staff for further clarification on (1) the accounting implications from a negative residual margin as a result of reinsurance pricing, (2) how the building blocks of the proposed measurement interact with the impairment test for the reinsurance asset, and (3) application of the proposed measurement and recognition approach including examples to illustrate the accounting for both the cedant and the assuming entity. ● Proposals on the accounting for ceding commissions did not include ceding commissions that relate to non-proportional reinsurance contracts, e.g. excess of loss, aggregate stop-loss etc. ● Concern was raised on how a reinsurer would determine what element of the reinsurance pricing covered acquisition costs since ceding commissions are not always explicit in the contract and may require calculation. In addition, accounting for a negative ceding commission was not addressed. 	

Timeline for Completion

The IASB published a revised timetable for the insurance contracts project with an anticipated release of the final standard in June 2011. The timeline aims for issuing an Exposure Draft in May 2010. Proposed timelines and key milestones are set out below:

Timeline	Topic for Discussion
To be decided by the Boards	Further discussions on the measurement objective, treatment of margins, unbundling and embedded derivatives, presentation of the statement of comprehensive income, reinsurance, unit-linked and index-linked insurance contracts, investment contracts and universal life contracts are expected in a future meeting.
March 2010	<p>Definition and scope Related projects include financial instruments and revenue recognition.</p> <p>Level of aggregation for the measurement of insurance contracts</p> <p>Disclosures Related projects include financial statement presentation.</p> <p>Business combinations – including definition and scope Related projects include financial instruments and revenue recognition.</p> <p>Recognition and derecognition (follow-up to previous discussions) Related projects include revenue recognition.</p> <p>Transition Related projects include financial instruments.</p> <p>Other follow-up items as a result of field testing:</p> <ul style="list-style-type: none"> ● Acquisition costs ● Contract boundaries ● Discount rates ● Unearned premiums approach. <p>Risk adjustment (follow-up to January meeting)</p> <p>Policyholder participation (follow-up to November meeting) Related projects include concepts (elements and recognition) and financial instruments with characteristics of equity.</p> <p>Pre-balloting</p>
April 2010	Sweep issues
May 2010	Publication of the Exposure Draft
September 2010	Comments due on the Exposure Draft
September 2010 - February 2011	Summary of comments and discussion on issues raised in the comment letters
March - May 2011	Pre-balloting and sweep issues
June 2011	Publication of final standard

The activities on this project may be monitored through the IASB website at <http://www.iasb.org> and the FASB website at <http://www.fasb.org>, which include summaries of the Boards' meetings, meeting materials and project summaries and status.

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