

## Moving toward global insurance accounting



This edition of *IFRS – Insurance Newsletter* highlights the results of recent IASB<sup>1</sup> and FASB<sup>2</sup> discussions related to the joint insurance contracts project.

### Recent decisions of the Boards

The IASB and the FASB (the Boards) deliberated the following topics on 1 and 2 March 2011:

- the use of a locked-in discount rate
- discounting non-life contracts
- scope, including financial guarantee contracts
- acquisition costs.

### Highlights

- Insurance contracts to be measured using a discount rate that is updated each reporting period.
- Post-claim liabilities to be discounted except when the effect is immaterial.
- Scope exceptions as proposed to be retained.
- IASB view: no change to the *current* treatment of financial guarantee contracts under IFRS; FASB view: will consider further whether change to *current* treatment of financial guarantees is needed under US GAAP.
- Acquisition costs to be determined at the portfolio level rather than the contract level.
- FASB view: *only* acquisition costs associated with successful contract acquisition efforts should be included in the cash flows; IASB view: acquisition costs would not be separated into successful and unsuccessful efforts.
- Further deliberation on acquisition costs is expected.

In addition the Boards held educational sessions on the preliminary results of field testing and uncertainty in the measurement of insurance liabilities.

### The use of a locked-in discount rate

The Boards agreed unanimously with the recommendation by the IASB and the FASB staff (the staff) that all insurance contracts are measured using a discount rate that is updated each reporting period. The following are key considerations made by the Boards in deciding that a locked-in discount rate was not appropriate:

- Using a locked-in discount rate may increase complexity and create operational issues as an insurer would need to supplement this treatment with an onerous contract test. It also may present some application difficulties, e.g. timing of onerous contract testing, the level of aggregation, how to deal with subsequent changes in discount rates, and tracking the discount rate based on the year of inception.
- An accounting mismatch may be created since cash flows include the effects of inflation, which would not be reflected in a locked-in discount rate.
- Creating multiple measurement models for long duration contracts would decrease comparability.
- FASB members felt that an approach that locks in a discount rate, similar to current US GAAP, would not be an improvement to US GAAP.
- There were no clear criteria for identifying which contracts would qualify for a locked-in discount rate based on how an insurer manages insurance liabilities.

The Boards recognised the concerns in some of the comment letter responses and outreach that volatility was an issue. However, they reiterated that volatility created from economic rather than accounting mismatches should be transparent. Many Board members felt that use of a locked-in discount rate would make economic mismatches less transparent.

The Boards plan to consider volatility issues further as they redeliberate the proposals on presentation and treatment of the residual margin.

### Discounting non-life contracts

The staff recommended that an exception to discounting post-claim liabilities should be made for short-duration short-tail claims in products for which the claim settling period typically is less than one year.

The Boards generally were not supportive of this recommendation. There was some confusion by the Boards as to what criterion had to be met in order to apply the recommended exception, i.e. coverage less than a year, settlement of claims in less than a year, or a combination of both.

Many of the IASB members disagreed with proposing an exception for discounting non-life short-tail post-claim liabilities for the following reasons:

- Scoping out short-tail claims may need to be done at a contract level rather than a portfolio level, which is inconsistent with the unit of account for measurement in the exposure draft and the discussion paper. Furthermore, several claims could be incurred under the same contract. If these claims had different characteristics, then it may result in treating different cash flows under the same contract differently, which would reduce the understandability of the results and be overly onerous for insurers.
- There is general opposition to making exceptions to the measurement model and preference is to have a more principles-based approach. Consistent with other aspects of IFRSs, most of the IASB members thought that if the effect of discounting was immaterial, then insurers may exclude the impact from their results. It was pointed out that in some jurisdictions with double-digit inflation, the effects of discounting for short periods of time may be material.
- Providing an exception for discounting was inconsistent with the axiom that an insurer most faithfully represents its position when it measures its liabilities in a way that includes the time value of money.

Some of the FASB members were concerned with using a materiality notion in the accounting guidance for measurement. Some Board members were uncomfortable with a materiality notion since it is not defined in IFRS. In addition, they were concerned that insurers in jurisdictions that currently do not have a materiality concept in their regulatory frameworks may struggle with such a concept. Some FASB members thought a materiality-based exemption could be overly onerous as an insurer would have to determine the effects of discounting in order to conclude it was immaterial.

The Boards agreed tentatively not to discount post-claim liabilities when the effect is immaterial. The Boards plan to evaluate possible guidance for determining when the effects of discounting are immaterial for short-tail claims in future deliberations of the modified measurement approach.

All members present supported the decision to discount all non-life long-tail post-claim liabilities.

### Scope

#### Scope exceptions

The staff proposed that the Boards retain the current scope exception in the exposure draft for fixed-fee contracts that have as their primary purpose the provision of services. However, they proposed to add an additional criterion that

these contracts also would need to qualify for the modified approach for short-duration contracts in order to meet the scope exception. The Boards generally did not see merit in adding this additional criterion. The staff also pointed out that the constituent feedback on this topic highlighted general confusion on how a service provider would determine whether the primary purpose of the contract was insurance or the provision of services, particularly as some would consider the provision of insurance to be a service.

Some FASB members commented that they wanted to ensure that roadside assistance programs were scoped out of the insurance proposals. Many IASB members disagreed with scoping out these contracts if they meet the definition of insurance. Roadside assistance programs offered in other jurisdictions vary significantly from those in the US where insurance risk may be less significant. The Boards agreed to leave the exception as it reads in the exposure draft, i.e. contracts that have as their primary purpose the provision of services would be excluded. It would be supplemented with further guidance on determining whether the primary purpose of the contracts was the provision of services. The Boards agreed tentatively to revisit this topic when deliberating the definition of an insurance contract.

The Boards agreed to retain the other scope exceptions as stated in the exposure draft and the discussion paper. The scope exceptions, other than fixed fee service contracts, include:

- product warranties issued by a manufacturer, dealer or retailer;
- employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item;
- residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease;
- contingent consideration payable or receivable in a business combination; and
- direct insurance contracts that the entity holds, i.e. direct insurance contracts in which the entity is the policyholder.

### Financial guarantees

The proposals in the exposure draft and the discussion paper included the deletion of the separate definition of a financial guarantee contract contained in IFRS 4 and IAS 39 *Financial Instruments: Recognition and Measurement* and the related measurement guidance in IAS 39. Financial guarantee contracts that meet the definition of an insurance contract

consequently would be in the scope of the future insurance standard.

Under IFRS, financial guarantee contracts generally are within the scope of IAS 39. Under IAS 39, financial guarantees are recorded at fair value and subsequently at the higher of the amount determined in accordance with IAS 37 *Provisions, Contingent liabilities and Contingent Assets*, and the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. However, if an issuer of financial guarantee contracts previously has asserted explicitly that it regard such contracts as insurance contracts and has used accounting applicable to insurance contracts, then the issuer has a choice to apply either IAS 39 or IFRS 4 on a contract-by-contract basis. Financial guarantees issued by an entity with no past practice of accounting for the contracts as insurance contracts would apply IAS 39.

Under US GAAP financial guarantee contracts currently are within the scope of:

- Accounting Standards Codification Topic 815 *Derivatives and Hedging*;
- Accounting Standards Codification Topic 944 *Financial Services-Insurance*; or
- Accounting Standards Codification Topic 460 *Guarantees* (formerly FASB Interpretation No. 45).

The accounting for financial guarantees varies depending on which guidance applies, including use of a fair value or an unearned premium model. Which guidance applies depends on the type of entity issuing the contract, i.e. insurer or non-insurer, and the type of contract, e.g. credit default swaps, mortgage guarantee insurance contracts, or other guarantees.

The Boards recognised that the treatment of economically similar instruments should be similar and the existing inconsistency in the treatment of financial guarantees in both IFRS and US GAAP. The Boards had received feedback from non-insurers on this matter during their outreach. Much of the constituent feedback received from banks urged the Boards to keep financial guarantees out of the scope of the insurance standard since they manage many of these contracts with other banking products such as loan commitments. These constituents were concerned that the proposed insurance model would place more demand on systems and resources than accounting for such contracts as financial instruments.

The IASB remarked that they viewed the lack of consistent accounting for financial guarantees as a gap in IFRS and thought this needed to be addressed. However, given the challenge with resolving the issues prior to the target deadline for the standard in June 2011, the IASB agreed tentatively with the staff's recommendation to *exclude* many

financial guarantee contracts from the scope of the insurance contracts project subject to the existing option in IFRS 4 that:

- permits an issuer of a financial guarantee contract to account for a financial guarantee contract as an insurance contract if it previously had asserted that it regard such contracts as insurance contracts and had accounted for them on that basis; and
- requires an issuer to account for a financial guarantee contract in accordance with the financial instruments standards in all other cases.

In addition, the IASB agreed tentatively not to provide an exception for intragroup guarantees from the accounting for financial guarantee contracts consistent with the current provisions of IAS 39 and IFRS 4.

The FASB similarly agreed that the Boards should aim to resolve the inconsistent accounting for financial guarantees under US GAAP. In addition, the FASB commented that the completion of the financial instruments project was crucial in evaluating whether the financial instruments standard or insurance standard was the most appropriate for these instruments. The FASB wants to consider this issue in the context of the final definition of insurance contracts and development of the insurance model, as well as the decisions on financial instruments impairment, with the goal of addressing it prior to the release of an exposure draft.

The FASB also decided tentatively not to amend the current US GAAP guidance in Codification Topic 460 that provides an exception to the recognition provisions for intragroup guarantees.

## Acquisition costs

The staff proposed two views on acquisition costs, highlighting the diversity in views on this topic.

The first view, supported by the FASB staff, recommended that acquisition costs included in the cash flows of an insurance contract should be limited to *direct* costs that are related to the acquisition of a *portfolio* of contracts. These costs would be limited to costs related to successful contract acquisition efforts.

The second view, supported by the IASB staff, recommended that acquisition costs included in the cash flows of an insurance contract should be:

- costs that *relate directly* to the acquisition of the portfolio, e.g. commissions; and
- costs that are *directly attributable* to acquisition activity and can be *allocated* to the portfolio.

These costs would *not* be limited to costs related to successful efforts.

Both recommendations would be supplemented with application guidance, at varying levels of detail, illustrating further the types of acquisition costs that would be included in the initial measurement of the cash flows of insurance contracts.

The exposure draft and the discussion paper both limited the costs to be included in measuring insurance contracts to those acquisition costs that are incremental at an individual contract level and excluded acquisition costs related to contracts not ultimately issued as well as allocated costs. The staff recommendations change the determination of eligible acquisition costs to the portfolio level, rather than the individual contract level, expanding the types of costs that potentially would be included in measurement.

In addition, based on the Boards' previous meeting, the use of the term incremental has been eliminated from the cash flow guidance due to its redundancy when considered with the notion of *direct* costs.

The Boards' discussions focused on the ultimate differences in the recommendations with a focus on which types of costs would be included in measurement under each recommendation.

Many IASB members observed that there should not be a distinction between successful and unsuccessful efforts because it may not be operational to identify which portion of the costs incurred relates to successful vs unsuccessful acquisition activities. One IASB member also stated that costs associated with unsuccessful contract acquisition efforts should not be excluded because they may provide a form of value to the overall insurance portfolio. Such activities may entail the rejection of contracts that have greater risk characteristics, i.e. higher likelihood of a payout in the future. Another IASB member indicated that 'abnormal' levels of costs should not be included in measuring insurance contracts but should be expensed when incurred.

The IASB members generally expressed a desire to keep the guidance on acquisition costs more principles based and consistent with the IASB staff recommendation. However, they suggested that the IASB staff supplement its recommendation with application guidance explaining further the meaning of *directly attributable to*, which might allow for some allocation of indirect costs rather than defining costs that may or may not fall into the definition.

In general, there was more of a desire from the FASB members to include detailed application guidance that would differentiate further between direct costs, e.g. commissions and premium taxes, and indirect costs, e.g. general overheads. In the case of allocated costs, there would be some judgement in determining if these costs were direct costs of a *portfolio*. An example would be a fixed cost such as rent. Some Board members felt if an insurer has one floor of a building occupied by only an underwriting department, some

allocated portion of rent for this floor may be considered a *direct* acquisition cost of a portfolio.

The FASB agreed unanimously that only acquisition costs associated with successful contract acquisition efforts should be included in the cash flows used to determine the initial measurement of a portfolio of insurance contracts. This decision is consistent with FASB Accounting Standards Update No. 2010-26 *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. However, the FASB agreed tentatively with the FASB staff's conclusion that only direct costs associated with contract acquisition should be included in measurement supplemented with application guidance to assist in the evaluation of whether a cost is directly related to contract acquisition.

The Boards asked the staff to revisit the meaning of 'direct' and 'directly attributable to' in drafting their respective application guidance, which will likely be brought back to a future meeting.

Although from a practical standpoint, there may not be significant differences in the types of costs the Boards would include in measurement under the two approaches, the way these costs are defined may vary. It remains to be seen whether the Boards are on the same page, other than inclusion of unsuccessful efforts for which the Boards are at opposite ends of the spectrum, as to the definition of acquisition costs.

Further deliberation and clarification on acquisition costs to be included in measurement of insurance contracts is expected.

### **Educational session – Uncertainty in the measurement of insurance liabilities**

The staff presented a paper that discussed uncertainty in the measurement of insurance liabilities. Specifically, the paper detailed how different risks and uncertainties are included in the building blocks, i.e. cash flows, discounting and risk adjustment. The paper was set forth primarily to address some Board members' concerns about potential double counting of risks in different elements of the building blocks. The paper was presented for educational purposes only.

### **Educational session – Preliminary field test results**

The Boards considered preliminary feedback received from the field testing of the IASB's exposure draft. The field testing was conducted between September 2010 and January 2011 and covered various aspects of the proposed insurance model including measurement, presentation and disclosure. The IASB staff indicated that the preliminary feedback they received was consistent with the feedback received in the comment letter responses. The staff felt no issues were raised to warrant revisiting previous decisions. However, certain Board members observed that it would be helpful for

the comprehensive field testing report to identify the specific issues noted by participants and discuss how the issues are or will be resolved.

## Timeline for completion

The IASB published a timetable in February for the insurance contracts project with an anticipated release of a future standard on insurance in June 2011. Based on this timeline, the remainder of March will be a crucial in determining whether the IASB can meet this target. Proposed timelines and key milestones are set out below:

Timeline	Topic for Discussion
March 2011	<p><b>Decision-making papers</b></p> <ul style="list-style-type: none"> <li>• Recognition</li> <li>• Definition of an insurance contract</li> <li>• Contract boundary</li> <li>• Discretionary participation features (DPFs) in the present value of cash flows</li> <li>• Unbundling*</li> <li>• Risk adjustment</li> <li>• Residual margin vs composite margin</li> <li>• Presentation (use of other comprehensive income)</li> <li>• Presentation (margin vs volume approach)</li> <li>• Acquisition costs</li> </ul> <p><b>Non-decision-making papers</b></p> <ul style="list-style-type: none"> <li>• Reinsurance educational session</li> <li>• Overview of unit of account</li> <li>• Other issues raised in the comment letters</li> </ul>
April 2011	<p><b>Decision-making papers</b></p> <ul style="list-style-type: none"> <li>• Investments with DPFs</li> <li>• Unbundling</li> <li>• Short-duration contracts</li> <li>• Discount rate follow up</li> <li>• Presentation of short-duration contracts</li> <li>• Unit-linked contracts</li> <li>• Reinsurance</li> </ul> <p><b>Non-decision-making papers</b></p> <ul style="list-style-type: none"> <li>• Other issues raised in comment letters</li> </ul>
May 2011	<p><b>Decision-making papers</b></p> <ul style="list-style-type: none"> <li>• Disclosures</li> <li>• Transition and effective date</li> <li>• Consideration of due process</li> </ul>
June 2011	<b>Publication of final standard</b>

\* *Topics expected to be subject to multiple discussions over the upcoming months.*

The [IASB's website](#) and the [FASB's website](#) contain summaries of the Boards' meetings, meeting materials, project summaries and status updates.

## Abbreviations and notes

- 1 IASB: International Accounting Standards Board
- 2 FASB: US Financial Accounting Standards Board

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