IFRS – Insurance Newsletter

November 2010, **Issue 10**

With the comment period on the IASB's[1] exposure draft on insurance contracts drawing to a close, our conversations with insurers have identified a number of topics that are likely themes in their comments. This special edition of our newsletter explains and examines some of these topics and their potential consequences.

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Background

Exposure Draft ED/2010/08 *Insurance Contracts* (the ED), published by the IASB in July 2010, proposes a new standard for accounting for insurance contracts. The IASB argues that significant improvements to accounting for insurance contracts are long overdue: "Many users of financial statements describe insurance accounting today as a "black box" that does not provide them with relevant information about an insurer's financial position and financial performance."

If implemented in their current form, the ED proposals would have a major impact on financial reporting for insurers. The associated changes in accounting policies and practices likely would have a significant effect on the assessment and perception of insurers' financial performance, both as between one insurer and another and between the insurance sector as a whole and other sectors. In addition, they may carry substantial implications for product design, data requirements, systems, controls and tax.

The ED proposals represent the latest stage in a process of debate and reform of insurance accounting, which has continued for many years. The FASB[2] joined the insurance project in 2008 and the ED proposals were the result of deliberations by both the IASB

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

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and FASB (the Boards). The Boards reached broadly similar conclusions in many areas, but placed different emphasis on certain areas, especially in respect of some key aspects of the measurement model.

The FASB published its own discussion paper, *Preliminary Views on Insurance Contracts* (the discussion paper), in September 2010. In addition to their routine invitations to comment, the Boards are planning to hold a series of public roundtable meetings in December 2010. The purpose of these roundtable meetings is to listen to the views of, and obtain information from, interested stakeholders about the discussion paper and the ED. Board members and staff are already seeking informal input in order to help finalise the project by mid June 2011.

Core principles

The Boards' proposals are based on a "fulfilment" objective for measuring insurance liabilities, which reflects the fact that an insurer generally expects to fulfil its liabilities over time by paying benefits and claims to policyholders as they become due, rather than transferring the liabilities to a third party. The measurement model is based on the idea that insurance contracts create a bundle of rights and obligations that work together to create a package of cash inflows (premiums) and outflows (benefits, claims and costs). In their respective proposals, the Boards have adopted slightly different approaches to the formulation of this model.

The IASB prefers a model with four building blocks. At initial recognition, an insurer would measure a contract as the sum of:

- the present value of the fulfilment cash flows, made up of:
  - an explicit, unbiased and probability-weighted estimate (i.e. expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract;
  - a discount rate that adjusts those cash flows for the time value of money; and
  - a risk adjustment, being an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows; and
- a residual margin that eliminates any gain at inception of the contract.

The present values of the fulfilment cash flows are re-measured each reporting period, whereas the residual margin is released over the coverage period.

The FASB prefers a measurement model that does not include a separate risk adjustment and residual margin, but instead combines these in a single composite margin for recognition in profit or loss over the combination of the coverage and benefit-paying periods of the insurance contract. This alternative approach does not give rise to differences at inception in most cases since both the residual and composite margin are calibrated to the consideration received for the insurance contract (premium received/receivable). However, a loss at inception is more likely to occur and is likely to be greater under a measurement approach that incorporates a separate risk adjustment compared to the composite margin approach. Differences also arise in subsequent measurement of the insurance contract.

Both measurement models are included in the discussion paper and the ED for further comment by constituents. Each Board's preferred measurement approach was selected based on a slim majority. A significant minority of the IASB supported the composite margin approach and a significant minority of the FASB supported an approach that includes an explicit risk adjustment. This underpins the request for constituent feedback on the measurement approaches.

Despite these differences of philosophy, the core features of the Boards' proposals are very similar.

For short-duration contracts, a modified version of the measurement model applies. As a proxy for the measurement model the insurer measures the pre-claims liability by allocating premiums over the coverage period. For these contracts, the insurer would apply the building blocks measurement model, excluding any residual or composite margin, to measure claim liabilities for insured events that have occurred already and for onerous contracts.

Implications and reactions

Based on a series of discussions and presentations involving our insurance industry clients and contacts we have observed that many are still on a journey to finalise their views and have yet to reach firm conclusions. Many of the Boards' proposals are highly technical, and much will depend on the details of their implementation. Views are diverse and consensus has yet to emerge. In some areas constituents believe that the Boards' proposals are unclear or inadequately specific; in others the implications are clear and give rise to concern. In this special issue of *IFRS Insurance Newsletter* we consider the key concerns in six key topic areas:

- recognition
- unbundling
- volatility
- presentation
- disclosure
- transition.

For simplicity, we refer to the ED in the text that follows.

The observations and views that we report in this newsletter are not the views of KPMG International Cooperative, a Swiss entity, nor of the member firms of the KPMG network of independent member firms affiliated with KPMG International Cooperative.

Observations reflect the distillation of many hours of discussion and debate with a broad range of insurance industry stakeholders around the world, and cannot and should not be attributed to any particular source or sources.

Our aim in issuing this newsletter is to stimulate debate amongst preparers and users of insurers' financial statements. The revisions to insurance accounting eventually agreed undoubtedly will have a major impact on how the industry accounts for and presents its performance and results, and will impact insurers of all sizes, in diverse geographies. In turn, these are likely to have significant carry over effects on internal reporting systems and processes. Beyond this, some insurers have indicated that the new regime may drive quite fundamental changes to the structure and viability of certain product lines and business models.

Everyone connected with the insurance industry ought to be engaging now in the debate and making their views known to the IASB and/or FASB.

Recognition

Historically, under most major accounting frameworks, recognition of the revenues and expenses associated with an insurance contract begins when coverage under the contract begins, unless the contract is onerous. Under the ED proposals, an insurer would recognise an insurance contract liability or an insurance contract asset as soon as the insurer becomes a party to the insurance contract, or possibly even earlier, when a binding offer is made, depending on the interpretation of the ED. The insurer would recognise changes in measurement from the date of initial recognition.

The ED proposes that insurance contracts would be accounted for at whichever is the earlier of:

- the date when the insurer is bound by the terms of the insurance contract, i.e. when there is an unconditional offer to provide coverage; and
- the date when the insurer is first exposed to risk under the contract. This is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and can therefore no longer change the price to reflect that risk fully.

The date on which the insurer recognises the insurance contract is particularly important in determining the residual margin an insurer recognises. At recognition, the insurer would measure the present value of the cash flows arising from an insurance contract, establish a risk adjustment and determine a "locked in" residual margin, which would be recognised subsequently as income over the contract's life.

In many cases, an insurer becomes party to an insurance contract before the coverage period starts. The ED proposes that during that time, the measurement of the insurance contract is updated for the cash paid or received, the accretion of interest, and changes in the estimates of cash flows and discount rates. Many insurers have commented that even if changes were confined to discount rates, the variations occurring between initial recognition and the beginning of the coverage period could be material.

Moreover, with some types of insurance contracts, the insurer may become party to the contract long before it considers that coverage starts, e.g. in cases of some deferred annuities with guaranteed terms, which are not triggered until payments are made or when annuitisation begins. In these cases, the residual margin might only begin to be recognised in profit or loss decades after initial recognition. Once the residual margin is locked in, any changes to forward projections, such as changes in estimated lapse rates and discount rates would be recognised immediately in profit or loss.

Insurers are typically not geared up in terms of systems and processes to capture the necessary commitment information early enough. In their current form, the ED proposals would result in an increased need for data accumulation and tracking for the purposes of recognising a contract. Many insurers are modelling now the potential impact of the ED proposals to determine the scale of the possible effect. If it turns out to be material, they may require significant systems changes or enhancements, which are likely to be both time consuming and costly. Conversely, if the impact for many insurers proves to be immaterial, the justification for the ED proposals may be undermined.

An alternative approach being discussed by some in the industry would require an insurer to recognise a contract when it becomes a party to it as proposed in the ED, except that any changes in assumption between initial recognition and the start of coverage would be recognised as an adjustment to the residual margin, which would not be amortised to profit or loss until coverage begins. Another approach suggested by some would be to recognise the contract only from the effective date on which coverage begins, consistent with some current GAAPs. Both approaches would be subject to an onerous contract test before the coverage period begins. These approaches reduce the accounting impact of changes in assumptions during the pre-coverage period, although insurers still may need to update systems and processes to address the new requirements.

Unbundling

Many contracts entered into by insurers embrace aspects of additional products and services in a bundle of rights and obligations, such as a deposit component or various ancillary commitments. Under the measurement model proposals in the ED these features would be unbundled from the insurance coverage and accounted for separately to the extent they are not "closely related" to the insurance coverage.

If a component is not closely related to the insurance coverage specified in a contract, then the ED proposes that an insurer would unbundle and account for that component separately. A significant degree of judgement may be needed to determine which components of a contract are not closely related to the insurance coverage specified in the contract. Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, e.g. an investment (financial) component or a service component.

The ED offers three examples to illustrate when unbundling would be required:

- an investment component reflecting an account balance that:
  - is credited with an explicit return, as opposed to an implicit return derived by discounting an explicit maturity value at a rate that is not explicitly stated within the contract; and
  - is credited with a rate that is based on the investment performance of an underlying specified pool of investments, which may include a notional pool for index-linked contract or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments, but may be subject to a guaranteed minimum return;
- an embedded derivative that is separated from its host contract under existing IFRS bifurcation guidance; and
- contractual terms relating to goods and services that are not closely related to the insurance coverage that have been combined with the insurance coverage for reasons that have no commercial substance.

The unbundling proposals in the ED may significantly impact life insurers who issue products such as special forms of universal life products, unit-linked and index-linked contracts, and participating contracts. In many cases universal life contracts and participating contracts have an explicit account balance and explicit credited interest. Following the example included in the ED regarding account balances, it does not appear that the unbundling requirement would be fulfilled in many of these contracts since there is no obligation to forward the entire investment return to policyholders. It is not entirely clear if these arrangements, which do not meet the full form of the example, would still be required to be unbundled under the closely related principle.

Non-life insurance contracts also may include a service component, such as claims processing, that can be provided as a separate stand-alone service in some circumstances, or which may be provided as an integral part of the insurance cover. Many believe that claim services are closely related to the insurance coverage and therefore should not be unbundled. However, there are shades of gray that require more judgement. For example, consider high deductible policies for which an excess of loss insurance is paired with a claims processing service and the insurance attaches at a level higher than the expected distribution of claims to be serviced. Should this component be unbundled or not? Given the limited application guidance currently included in the ED, it is not clear how such situations should be evaluated.

In developing their proposals, the Boards explored originally whether more specific detailed principles could be formulated to determine when to unbundle different components of an insurance contract. Specifically, they considered as a starting point whether a component can introduce variability in the overall cash flows of the insurance contract for risks that are not considered part of the provision of insurance protection. In addition, they considered the relevance of factors such as:

- the policyholder's ability to obtain some or all of the contract value through withdrawal or redemption; and
- the nature of the risks that are transferred by a component, e.g. whether primarily financial or not.

However, these examples are far from comprehensive, and many insurers believe that they do not in themselves serve to establish a clear principle for unbundling. The closely related principle may be familiar to users and preparers in the context of embedded derivatives. However, the example relating to an investment component, for example, does not fully explain how the principle might be applied in practice across a wide variety of situations to determine whether and what components may or may not be closely related.

In considering the implications of the unbundling proposal in the ED, insurers have become concerned about a number of practical issues. One which arises immediately is what accounting approach is likely to be applicable to an unbundled component? There have been some who have questioned whether there is a need for unbundling under the proposed measurement approach, which is based on discounted cash flows and provides less room for accounting arbitrage as compared to many traditional models. On the other hand, given concerns about volatility, some insurers would prefer to carry unbundled investment components at amortised cost.

A second concern is how fiscal authorities will assess unbundled components. Many insurance products currently attract favourable tax treatment. If components are separated, will taxing authorities reconsider the tax treatment of these components, possibly subjecting them to more onerous tax requirements as a result of these not being considered part of the insurance model? There also may be adverse tax consequences for policyholders currently receiving favourable tax treatment on the entire cost of an insurance product.

Pricing is a third issue. Typically composite insurance contracts embracing ancillary services are priced as unitary products. It may not be at all easy to disentangle the cost and revenue aspects of separate unbundled components. Some insurers believe more-or-less arbitrary allocation may be necessary in many cases, e.g. if a contract is unbundled, incremental acquisition costs would need to be allocated between the unbundled components.

The principle of unbundling, and of applying new insurance accounting principles only to the insurance components of a contract, clearly has logical force. But many insurers believe unbundling will not be performed consistently without expanded principles or additional application guidance. Without such guidance, it will be difficult to determine which services are closely related to the insurance component and which are not. Examples that address circumstances in which unbundling is *not* required may also be useful.

Volatility

Insurers are concerned that the ED proposals will result in a significant increase in the volatility of reported profitability and counter-intuitive balance sheet impacts. Underlying these concerns is a tension between the desire for transparency as to the short-term impact of changes in current expectations in profit or loss, which is at odds with the inherent very long-term nature of many insurance business models. Many insurers believe a better resolution needs to be found.

The ED proposals include a measurement approach that includes a discount rate for insurance liabilities based on their characteristics, i.e. a risk-free rate plus an adjustment for illiquidity, as opposed to the return on invested assets. In addition, the effects of changes in assumptions, whether financial such as interest rates or non-financial such as mortality and morbidity rates, would be required to be recognised in the balance sheet and profit or loss each reporting period.

A key concern that many insurers have expressed to us is that all income and expenses from insurance contracts will be presented in profit or loss, and those income and expenses may be highly volatile and significantly affected by market value movements and changes in estimates. For those insurers that carry investments at amortised cost, whether under IAS 39 *Financial Instruments: Recognition and Measurement* or, in the future, under IFRS 9 *Financial Instruments*, this may present a significant accounting mismatch, notwithstanding the view in the discussion paper *Preliminary Views on Insurance Contracts* published by the IASB in May 2007 that an ideal measurement model should not create any accounting mismatches.

It is expected that in order to achieve as much accounting consistency as possible in recording changes in liabilities and assets, many insurers may apply IFRS 9 in such a way that an insurer's assets that support insurance obligations are measured at fair value with changes recognised in profit or loss.

Problems arise from the very long-term nature of many insurers' liabilities. In the case of life insurance contracts, the insurer may have an obligation to pay out up to 60 or 70 years in the future. At the longer durations it is effectively impossible to find matching assets in the marketplace with comparable maturities. So insurers' assets typically have a shorter-term profile. The economic risk this poses, i.e. the risk of assets being insufficient to meet liabilities, is in practice sustainable because by the time the liability crystallises appropriate asset cover will have been secured.

Clearly, the valuation of insurance liabilities is sensitive to the discount rate adopted; changes in market interest rates will change the discount rate assumption, requiring a loss (or gain) to be reflected in profit or loss. This causes concerns, since liabilities recorded under the proposed model will become highly volatile as a consequence of changes in discount rates. A further concern is that since there is no active market for such long-term liabilities, an appropriate discount rate has to be determined by modelling, which introduces a major dimension of subjectivity into the accounting.

On the asset side, a key driver of valuation is credit spreads reflecting the adverse perceptions of financial market participants regarding counter party default; when current circumstances lead to a change in the assessment of counter party risk, this results in an impact on profit or loss. Since there is no corresponding change on the liability side because the discount rate for insurance obligations excludes any adjustment for the insurer's own credit risk, the consequence is further mismatch between assets and liabilities, and additional volatility.

Significant balance sheet inflation and deflation also can result from comparatively short-term market changes. Theoretically, assets and liabilities tend to move in concert, so if interest rates increase both assets and liabilities will increase in value. But if durations of assets and liabilities do not match or if credit spreads change, these movements do not correspond. Apart from the variation in balance sheet values this implies, it can lead to pressure to increase distributions in "good" times.

Such volatility is arguably unrelated to the long-term stability of an insurer. And it may mean that headline financial results are less useful for predicting long-term performance: these fluctuations may make it more difficult for users of an insurer's financial statements to assess the insurer's long-term stability. It may also result in distorted perceptions of the insurance sector as a whole relative to other sectors such as banking. As a consequence there is a concern that the insurance sector, which bears already a high cost of capital, will continue to carry this burden. Furthermore, in an effort to mitigate earnings volatility, insurers might avoid writing longer-term products. This is counter-intuitive, as it is longer-term products that often generate the stable and predictable returns favoured by investors.

There are indications that the IASB appreciates these concerns and the insurance sector is working to develop alternative solutions.

A number of approaches are currently being discussed:

- accept the impact of volatility as a reflection of the underlying economic mismatch in the insurance business model, but reflect it in a more transparent way in profit or loss by electing a fair value model for underlying assets and applying the current proposed measurement model for insurance liabilities as is;
- take some or all of the changes in forecast values and liability measurement to other comprehensive income;
- apply different discount rates to insurers' liabilities, e.g. those related to expected asset returns, thereby eliminating (much of) the mismatch; and
- allow the residual margin, i.e. liability to eliminate any gain at inception that is subsequently amortised over the coverage period, to be remeasured to absorb the effects of some or all changes in the measurement of insurance contract cash flows.

The business model of insurers poses particular challenges to efforts to make financial reporting both realistic and informative. The drive towards greater use of fair values and other measurements that reflect up-to-date market variables to reflect current reality is understandable. However, it needs to be balanced by avoiding short-term volatility that is not reflective of the long-term nature of some insurance contracts.

Presentation

The presentation proposals in the ED represent a fundamental change in the architecture of financial statements for insurers. The ED proposes that the combination of rights and obligations arising from an insurance contract would be presented as a single insurance contract asset or liability, with each portfolio of insurance contracts presented as a single net item within captions for insurance contract assets or insurance contract liabilities. In addition, the ED requires a summarised presentation model for reporting income and expense arising from insurance contracts based on margins consistent with the new measurement model, except when the modified approach is adopted for some short-duration contracts.

Under the ED proposals, all income and expenses from insurance contracts would be included in profit or loss. This would be based on margins consistent with the building blocks measurement model and would be more summarised than the approaches traditionally used by insurers. Premiums and claims generally would not be presented in the statement of comprehensive income on the basis that they represent settlements of insurance contract assets or liabilities and not revenues or expenses, although related information would be provided in the notes to the financial statements. Changes in the risk adjustment, changes in the residual margin and changes in estimates would be disclosed either on the face of the statement of comprehensive income or within the notes to the financial statements.

The ED proposes that assets, liabilities, income and expenses from unit-linked contracts, and the assets underlying such contracts, are presented as separate line items and are not commingled with other line items.

Significant impact for key performance indicators and performance metrics

The presentation proposals in the ED will involve significant changes to key performance indicators and performance metrics. In our experience, users of insurers' accounts have been concerned more by the lack of comparability and lack of transparency arising from the different approaches to recognition and measurement permitted by IFRS 4 *Insurance Contracts*, than by flaws in the basis of presentation, i.e. the problems are primarily issues of measurement and lack of consistency in approaches, rather than presentation.

Insurers who already value insurance contract liabilities using current market rates of interest, or who use the fair value option for significant portions of their investment portfolios, have become proficient at explaining the impact of market movements on their results. For example, a recent KPMG survey* of the results of 16 European insurers, showed that 15 of the 16 insurers presented some form of underlying (or operating) result that typically excluded the effects of short-term fluctuations in investment returns. This practice is likely to remain widely used.

Does the presentation reflect a fulfilment value notion?

Some commentators have suggested that the presentation proposals in the ED appear at odds with the fulfilment value notion, since the presentation aspects of the ED proposals focus unduly on reporting the effects of short-term fluctuations when insurers have to hold their insurance contract liabilities to maturity or earlier lapse or surrender, and generally endeavour to match assets and liabilities.

* Insurance Reporting Round-up Survey – Based on the 2009 year end results of European insurers

Loss of familiar metrics in the statement of comprehensive income

Many insurers are concerned that recognisable landmarks such as premiums and claims would no longer feature in the statement of comprehensive income. Even when familiar metrics are used in the premium allocation approach required for short-duration contracts, these may not be comparable with previous reporting bases. For example, the ED proposes additional disclosures on the face of the statement of comprehensive income for short-duration contracts. Our initial analysis suggests that:

- Premiums subject to release over the coverage period would reflect the present value of all amounts expected to be received, i.e. net of discounting. At present, estimates of premiums earned are usually undiscounted and for some accounting models reflect only those premium instalments contractually due within the reporting period.
- Claims would reflect the present value of all cash flows expected to be paid net of discounting for contracts that are recognised in the reporting period but would not include changes in estimates in respect of contracts recognised in previous periods, which would be reflected as changes in estimates. At present the headline claims number generally is undiscounted and includes changes in claims estimates from prior periods.

The ED proposes that premiums and claims are disclosed as important measures as they link changes in estimate to amounts paid and received during the year. However, they are not a proxy for revenue and expenses. Instead they are activity and cash measures and are more similar in nature to the activity measures of new deposits, loans issued and assets under management reported by banks and fund managers.

What about the potential impact for investors?

Investors and analysts have a keen interest in financial reporting by insurers. Some analysts and investors have expressed concerns that insurance accounting lacks transparency and is open to management bias. Some users of financial statements may be concerned that insurance accounting will become even more opaque and subjective and will become yet more difficult to penetrate as they lose familiar sense checks of premiums and claims.

Options/alternatives available

As an alternative to the summarised margin approach proposed in the ED, the IASB considered but rejected three alternative options:

- an "expanded margin" approach in which both changes in the risk adjustment and the release of the residual margin are presented in profit or loss, together with some or all of policyholder claims and benefits and other expenses;
- two "premium" approaches; one for long-duration contracts reflecting premiums received as revenue, with a corresponding increase in the liability recognised as an expense; and one for short-duration contracts, with premiums earned reflecting a release from the pre-claims obligation as insurance coverage is provided. These approaches resemble the traditional non-life and life presentation models used in many jurisdictions; and
- a combination of a margin approach and a premium approach.

Field testing on presentation was relatively limited and, we understand, did not address how insurers might tackle explaining their performance under the summarised margin approach that the ED proposes. The expanded margin approach was rejected on the grounds of cost and because of how revenues were reflected in profit or loss. Specifically, the Boards were concerned that revenue cannot be determined directly but rather would need to be imputed by "grossing up" the change in the margin by some or all of the claims and expenses. These are issues that insurers may want to test through simulation and modelling, identifying the key drivers of their results, how these might be explained to users of the financial statements and testing the extent to which traditional metrics can be married to the ED's proposed approach.

Disclosure

IFRS 4 contains extensive disclosure requirements for insurers. Insurers are concerned that the ED proposals represent a significant increase in the degree of granularity in disclosures. They may impose substantial extra costs for gathering additional information and have a corresponding impact on systems expenditure. In addition, some insurers have raised the concern that the information required to be disclosed may be commercially sensitive and others have concerns as to whether the volume of data can be generated in the short reporting periods in some jurisdictions.

The disclosure proposals in the ED require:

- additional reconciliations of balances as a result of the new measurement model;
- a more detailed disclosure of methods and processes for estimating inputs compared with IFRS 4;
- the confidence level to which the risk adjustment corresponds (whichever of the three methods is used);
- expanded disclosure of measurement uncertainty analysis;
- information on the regulatory framework in which the insurer operates; and
- quantitative information on sensitivity to insurance risk gross and net of risk mitigation, whereas IFRS 4 currently permits a choice of qualitative or quantitative disclosure.

Investors generally favour granular disclosures that aid comparison between entities. In the life sector investors are keen to understand the profit profiles of different cohorts of business and the estimated time period over which these will monetise to cash. For non-life insurance many commentators have expressed favour for loss development tables presented on an accident year basis rather than a calendar year basis in order to allow better tracking of pricing and reserving over time. Some non-life insurers already voluntarily disclose "rate strength indices".

However, some insurers have expressed some concern about the extensive nature of the disclosures, the degree of granularity of analysis required and the potential for overlap between the various requirements. For example, they believe there is an overlap between the requirement for a measurement uncertainty analysis required by paragraph 90(d) and the sensitivity to insurance risk required by paragraph 92 (e)(i).

Many insurers have commented that they would prefer an approach that was more principles based and less prescriptive. Many insurers have been enhancing disclosures voluntarily in order to explain the characteristics of their business more clearly, and in response to investor pressure. We note that investors generally favour information that can be readily reconciled to actual financial statement balances and cash flows. This is a useful dimension of the disclosures proposed by the ED.

Most listed insurers have a good understanding of the disclosures that are valued by users. These are generally a blend of information that is provided in the financial statements and in other sources such as the MD&A[3] and investor briefings. Smaller insurers may need the greatest guidance. The quantitative risk disclosures in IFRS 7 *Financial Instruments: Disclosures* provide a useful model. These disclosures are provided "through the eyes of management" subject to also satisfying certain mandatory minimum requirements.

Transition

In considering the transition process to the new regime, the ED proposes to derecognise all insurance contract assets and liabilities recognised in the pre-transition balance sheet and to recognise contract assets and liabilities measured under the new standard, but with no residual margin at the date of transition. However, this simplification of the transition rules results in an unintended consequence, particularly for life insurance - embedded profits would be recognised in equity at the transition date therefore depressing future earnings from profitable contracts in force at the date of transition.

Representatives of the life insurance industry have expressed concern that the ED proposals may result in a significant reduction in reported earnings compared to their current accounting bases. They believe this would put insurers at a comparative disadvantage to other industries and would distort capital and earnings ratios. It would also result in the application of different accounting models for business acquired pre and post transition, and for long-duration contracts this situation would perpetuate for a considerable period of time. The insurance industry, or at least many life insurers, appears to be united in its view that a viable alternative to the ED proposals should be found. In a webcast on Monday 25 October, the IASB staff also acknowledged the need for further work on transition arrangements.

However, although a number of possible options have been identified, each method has its limitations and a clear preference has yet to emerge. Two alternative approaches were considered but rejected by the IASB:

1. A fully retrospective approach. This approach could be done in two ways, either without hindsight, which is the method generally required by IFRSs requiring retrospective application, or with the benefit of hindsight. In practice, it would be difficult not to use hindsight, because it is unlikely that the data originally used to price products would have been maintained. It is arguable that a residual margin calculated with the benefit of hindsight would be less subjective and would theoretically be less subject to bias at transition. However, a fully retrospective approach would generally necessitate maintenance, or reconstruction to a reasonable degree of accuracy, of all of the relevant contract history data in order to undertake the necessary calculations. The IASB considered that full retrospective determination of the residual margin would sometimes be impractical and, if not impractical, would often cause costs disproportionate to the resulting benefit for users. Some insurers are currently considering the practicalities of performing full retrospective application although this is not currently an option under the ED proposals.

2. An approach that treats the difference between the present value of future cash flows measured under the building block approach and the pre-transition carrying value of contract assets and liabilities as the residual margin.

   This method was rejected by the IASB because the resulting residual margins for contracts written before the date of transition would not be comparable with residual margins for contracts written after the date of transition, and this difference would perpetuate for an extended time frame differences between accounting models adopted under IFRS 4. Some insurers have expressed concern that this method would favour insurers with very prudent current reserving bases compared to those with more realistic bases.

An alternative approach being considered by some, which was not discussed by the IASB, would be to calibrate a residual premium based on current prices. Under this approach, the present value of future cash flows would be compared with the premium that the insurer would charge at the balance sheet date for a contract with similar conditions and remaining terms. The insurer also would need to determine the current level of incremental acquisition costs for a similar contract in order to establish a current entry price for the residual margin, reflecting the current expected future profits in the contracts on transition. Whether this approach is any more feasible than retrospective application is not at all clear, particularly in relation to contracts that are no longer written or when the business model has changed. However, it would appear that using current prices and cost estimates for contracts that are still open to new business may be easier for many insurers than delving back into the mists of time.

Contact us

We hope that readers have found this round up of current views and observations informative and thought provoking. Views on the ED are diverse. Everyone connected with the insurance industry should be joining the debate and making their views known to the IASB and/or FASB. We welcome hearing your views and discussing and debating them with you.

KPMG has also issued a publication *New on the Horizon: Insurance Contracts,* which considers the proposed requirements of the ED. It also provides a high-level overview of some significant changes to current practice expected in the accounting for insurance contracts if the ED proposals are finalised as a new IFRS. A copy of this publication can be accessed at kpmg.com/ifrs.

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Abbreviations

1 IASB: International Accounting Standards Board
2 FASB: US Financial Accounting Standards Board
3 MD&A: Management Discussion and Analysis

Publication name: *IFRS – Insurance Newsletter*

Publication number: Issue 10

Publication date: November 2010