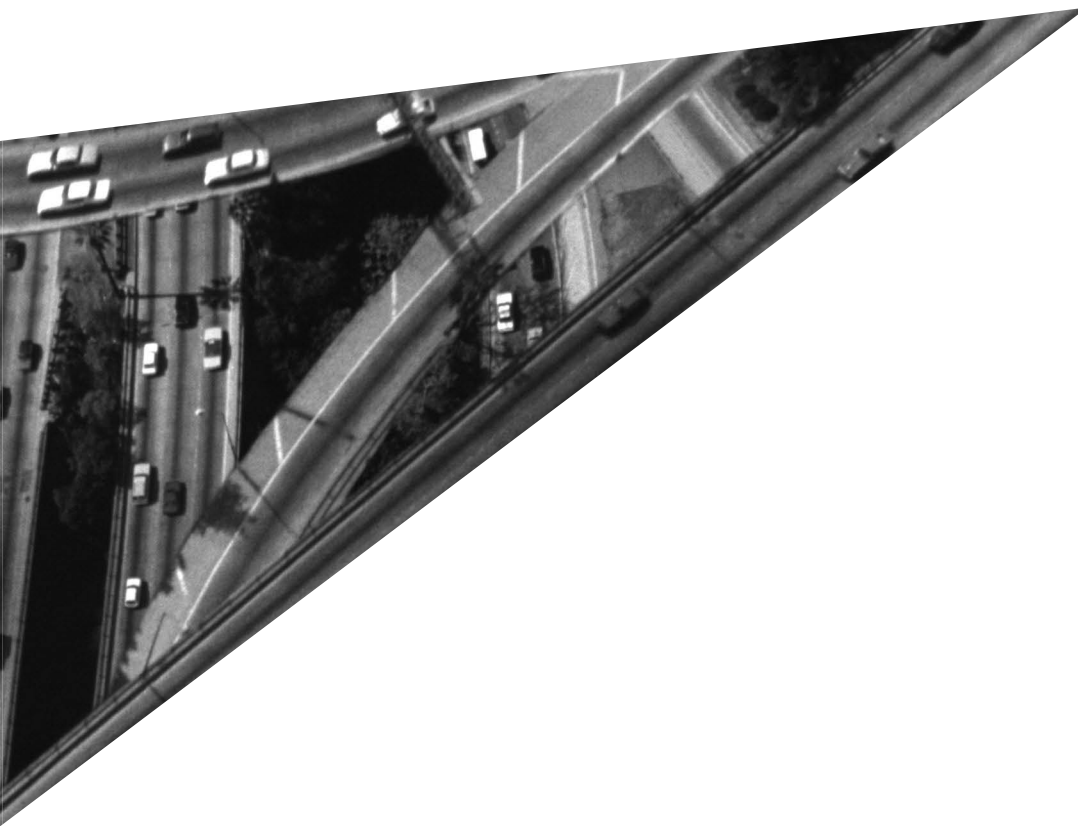


IFRS at the crossroads

US GAAP vs. IFRS: key differences in
accounting for insurance contracts



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by Christine Holmes

The International Accounting Standards Board (IASB [the Board]) recognized that it was not feasible to complete a comprehensive project to draft accounting standards for insurance contracts in time for implementation in 2005 by insurance companies in the European Union, so it split its project on how to account for insurance contracts into two phases. Phase I of the project which is represented in IFRS 4 Insurance Contracts (IFRS 4 or the Statement), was developed to avoid unnecessary disruption for both preparers and users of insurance company financial statements until the Board completed Phase II of the project.

The Board's objectives in developing IFRS 4 were "(a) making limited improvements to accounting practices for insurance contracts, without requiring major changes that may need to be reversed in Phase II and (b) to require disclosure that (i) identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and (ii) helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts." In many cases, an insurer was able to continue measuring insurance liabilities under its existing GAAP requirements with few exceptions.

The Statement contains certain guidance changes regarding reserves and liability adequacy tests, which drove financial statement changes in certain jurisdictions. However, these requirements were already included under US GAAP.

As a result, IFRS 4 does not significantly change accounting for insurance contracts for US GAAP preparers when converting



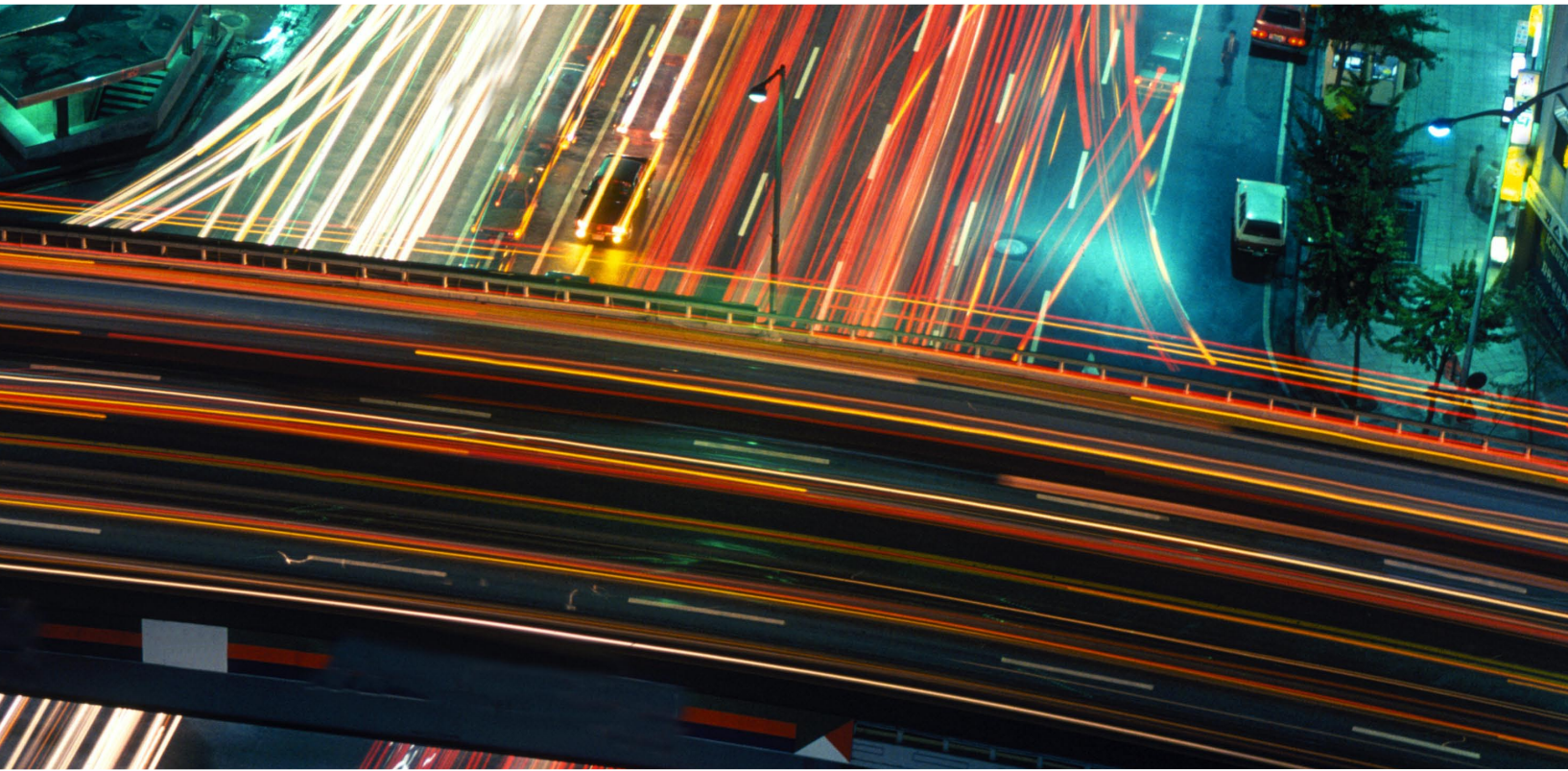
A proposed new accounting standard would herald a fundamental change in the finance and actuarial functions of insurance companies.

to IFRS, notwithstanding the difference in the definition of "insurance contracts." The difference in definition affects the classification of some specific products including Guaranteed Insurance Contracts, certain annuities, and Single-Premium Deferred Annuities.

Accounting for insurance contracts under Phase II

In May 2007, the IASB issued its Discussion Paper *Preliminary Views on Insurance Contracts* (the Discussion Paper) and an invitation to comment on this paper by 16 November 2007. The Discussion Paper outlines the Board's preliminary views on the main components of an accounting model for insurers to follow for insurance contracts they issue. The Discussion Paper noted that the Board will consider the responses in modifying or confirming its views and then issue an exposure draft for public comment.

In August 2007, the Financial Accounting Standards Board (FASB) issued an Invitation to Comment on "An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, *Preliminary Views on Insurance Contracts*" (the ITC). The ITC



requested input from FASB constituents on whether the FASB should authorize a joint project with the IASB to develop a comprehensive standard on accounting for insurance (including reinsurance) contracts that would replace all existing US GAAP and IFRS for insurance contracts.

In November 2007, the Securities and Exchange Commission (SEC) approved rule amendments supporting the use of IFRS in preparation of financial statements by foreign private issuers in the US, noting that the statements will be accepted without reconciliation to US GAAP if they are prepared using IFRS as issued by the IASB. The final rules apply to financial statements covering years ended after 15 November 2007.

In addition, the SEC recently expressed its receptivity to IFRS and issued a concept release to obtain information as to whether US issuers should have the option to prepare financial statements in accordance with IFRS. Following these amendments, the SEC held two roundtables to collect more feedback from the public on the issue of giving US domestic issuers the same option that foreign issuers have to use either IFRS or US GAAP

for financial statements filed with the SEC.

Considering the current focus on IFRS and the desire to converge IASB and FASB accounting models, we provide a discussion of the more critical elements of the accounting proposed in the Discussion Paper for insurance contracts under Phase II that differ significantly from existing US GAAP.

This is not a comprehensive list or detailed review of the potential accounting and financial reporting matters that would change for companies operating in the insurance industry, but a high-level overview of certain preliminary views contained in the Discussion Paper that have sparked considerable discussion among industry participants.

Current exit value—effect on profit streams

The Discussion Paper proposed to measure insurance liabilities at “current exit value” (CEV), a measure that is very similar to the definition of “fair value” in SFAS 157 “Fair Value Measurements” (SFAS 157). CEV is defined as the amount that an insurer would expect to pay at the reporting date to transfer its remaining contractual rights

and obligations immediately to another party. SFAS 159 “The Fair Value Option for Financial Assets and Financial Liabilities” (SFAS 159) permits entities to choose, at specified election dates, to measure eligible items at fair value. The election under SFAS 159 is applied on an instrument-by-instrument basis, may not be revoked and may only be applied to an entire instrument.

Early indications from the insurance market reflect that virtually all insurers reporting under US GAAP, in accordance with SFAS 159, will not elect to mark insurance liabilities to fair value. However, if the proposed CEV measurement becomes guidance under phase II and if the FASB elects to join the IASB in developing this standard, the application of CEV to insurance liabilities would not be at the entities’ discretion; rather, it would be required upon adoption of the new standard.

As the CEV for insurance contracts is generally unobservable, the Discussion Paper says it has to be estimated using three key building blocks: 1) current, unbiased market-consistent probability-weighted estimates of future cash flows,

2) discounted at current market interest rates, with 3) explicit risk and service margins added to the liability.

Each of the building blocks is further discussed as follows:

(1) Estimates of future cash flows. To the extent that inputs used to calculate the cash flows relate to observable market variables, the IASB requires the inputs to be consistent with current observed market prices. However, for most insurance contracts, many significant variables will not be observable in the market. The IASB recognizes that, for these assumptions, insurers will generally use internal data to estimate the data that market participants would use. The Discussion Paper noted that, in practice, the IASB expects that an insurer would use estimates of its own servicing expenses, excluding any service margins, unless there is clear evidence that the insurer is significantly more or less efficient than other market participants.

The measurement of the liability should reflect only cash flows generated by the insurance contract and should not capture cash flows that are specific to the entity and that result from synergies between the insurance liability and other assets and liabilities. Thus, the measurement should not capture cash flows that are entity-specific and that would not arise for other market participants. This limitation does not mean that cash flows may not be entity-specific as long as they are consistent with estimates that other market participants would make in valuing the liability in question.

(2) Estimated cash flows would be discounted at current market interest rates. This issue is contentious in the non-life sector because the criteria to allow discounting generally is a high hurdle for non-life liabilities, and therefore, very few companies presently discount these liabilities. Under SAB 62, "Discounting by Property-Casualty Insurance Companies," insurers reporting under US GAAP may discount claims liabilities arising from short-duration contracts as long as they meet the criteria outlined in the SAB (payment pattern and ultimate cost are fixed and determinable on an individual claim basis). As a result, in practice, the discounting of short-duration liabilities under US GAAP is limited to a few contract types (e.g., workers' compensation indemnity). The Discussion Paper listed arguments for and against discounting but concludes that to be consistent with the IFRS measurement principles for comparable liabilities, all claims liabilities should be discounted.

(3) Explicit risk and service margins would be added to the value of the liabilities based on an unbiased estimate of the compensation that market participants would demand to accept the obligations. Margins would be calculated for a portfolio of contracts that are subject to broadly similar risks and are managed together.

The IASB stated in its Discussion Paper that it "does not intend to prescribe specific techniques for developing risk margins. Instead, the Board intends to explain the attributes of techniques that will enable risk margins to convey useful information

to users about the uncertainty associated with risk margins." Subsequent to the issuance of the Discussion Paper, the IASB staff issued a document titled "Frequently asked questions: service margins" to assist industry participants in understanding the attributes of service margins; therefore, it is possible that the IASB may issue similar guidance for other types of margins. In the absence of a "frequently asked questions" document related to risk margins, the International Actuarial Association (IAA) has commenced work on developing guidance for setting risk margins. This project of the IAA was undertaken in response to a request from the International Association of Insurance Supervisors (IAIS) for guidance in this area. The IAIS is developing a measurement framework for Solvency II purposes that it hopes will differ little, if at all, from IFRS, as this framework will also be needed in European regulatory computations.

One area of contention for insurance companies, which is more significant to life companies, is over the potential recognition of Day 1 gains. The Discussion Paper outlined two implementation options (A and B) for the calibration of risk margins. Under Option B, the insurer would recognize a Day 1 gain if a market participant were to charge a lower premium than the insurer for the same insurance contract (i.e., when the value of the liability as calculated using CEV on inception date is less than the actual premium charged to the policyholder, profit is recognized at inception of the contract).

Under Option A, the risk margin included

The IASB stated that it does not intend to “prescribe specific techniques for risk margins.”

in the measure of an insurance liability at inception of the contract would be calibrated to the actual premium charged to the policyholder. This means that the risk margin would be set at a level that makes the value of the liability equal to the premium charged after deduction of the amount needed to pay for related acquisition costs. The rationale is that, in general, the market price (the premium charged) is the only observable value at inception of the contract.

The majority of IASB members support Option B and take the view that the transaction price should not override the unbiased estimate of the risk margin that market participants would require to take over the insurer’s contractual rights and obligations.

Based on preliminary modeling of profit streams for a few types of insurance products, we see some very different patterns under Option A versus Option B. Initial modeling, for a fairly simple universal life product where Day 1 gains are permitted to be recognized, reflects that significantly higher profit is recognized in the first year and lower profit is recognized in future years. Where Day 1 gains are calibrated to premiums, the profit stream is more level across the years.

If the Board, based on comment letters received on the Discussion Paper, does not change its point of view and continues with a CEV and Option B, there will be a significant change to the valuation of liabilities and the recognition of profit. Additionally, the systems necessary to support the CEV (or why an existing transaction does not

represent an observable market value) are expected to be substantial. If the Board chooses a CEV and Option A, there will still be differences from US GAAP, but the differences should be less significant.

Deferred acquisition costs

With the exception of accounting for origination costs, the ability to defer acquisition costs and to amortize them over a future period have long represented a departure from accounting policies in other industries. Phase II proposes that acquisition costs should be expensed when incurred; however, in recognition that a portion of the premium actually represents a recovery of those acquisition costs, the Discussion Paper suggested that this portion be recognized as income to offset the related acquisition costs actually incurred. This represents a significant departure from current US GAAP, which allows certain costs to be deferred and then amortized over the life of the contract.

Unbundling of service and deposit components

Insurance companies sell a variety of products that may contain a number of different features bundled into a single contract (e.g., variable annuities with guaranteed minimum death benefits). SFAS 97, “Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,” recognized that a single contract (e.g., unit-linked contracts) may contain both deposit and insurance components. Some accounting theorists argue that, in such cases, an insurer should unbundle the

different components and account for them separately. The main argument in favor of unbundling is that it more properly reflects the economics of the relationship, and it avoids sharp differences in accounting that may arise between contracts that contain just enough insurance risk to qualify for insurance accounting in terms of the IASB’s definition of insurance and those that do not. The Discussion Paper documented the main differences between the proposals for insurance accounting and the current accounting for investment contracts under IAS 39 and recognition of revenue from certain types of transactions and events under IAS 18.

The IASB acknowledges the argument that unbundling may often be impractical. Therefore, the Discussion Paper stated that if an insurance contract contains both an insurance component and a deposit component, the insurer should treat it as follows:

- (1) If the components are so interdependent that they can be measured only on an arbitrary basis, the Phase II standard on insurance contracts should apply to the whole contract.
- (2) If the components are not interdependent, the Phase II standard should apply to the insurance component and IAS 39 should apply to the deposit component.
- (3) If the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The insurance component would be measured as the



difference between the measurement of the whole contract and the measurement of the deposit component.

The Discussion Paper expressed no view on how insurance premiums should be presented in these situations and merely noted that premiums can either be presented as revenue or recognized in the balance sheet in a way similar to bank deposits. The IASB has not expressed a clear view because there is another IASB project exploring performance reporting.

Future expected premiums

While insurance entities can provide incentives to policyholders to maintain their policies, insurers cannot compel policyholders to keep their policies in force. If a policyholder fails to pay premiums, the insurance contract will lapse or expire. Currently, there are many non-insurance executory transactions in which the purchaser has not only the right but the obligation to execute the transaction, and yet the seller does not recognize the transaction until it receives payment.

In contrast to existing accounting for future payments for non-insurance executory contracts, under the provisions of the Discussion Paper future expected premiums would be included in the estimated cash flows, but only to the extent that the policyholder would need to continue paying them to retain coverage at a contractually constrained price without reconfirmation of risk profiles. Future premiums would also be included where the insurer expects an economic loss if

policyholders continue paying them.

The Discussion Paper indicated that a number of IASB members disagree with a model that allows future premiums to be recognized in the estimation of the insurance liability. These members believe that insurers should not recognize net economic benefits from future premiums if they cannot compel the policyholders to pay those premiums. Some IASB members believe the test of guaranteed insurability is open to inconsistent application and potential abuse. These members believe that instead of including these future premiums as a deduction from the liability, an insurer should recognize separately a customer relationship asset at contract inception.

The rationale for both guaranteed insurability and partial recognition of an intangible asset for a customer relationship appears inconsistent with many existing accounting principles, including the general concept of presenting assets and liabilities separately. The implications of allowing such an approach for the valuation of insurance liabilities could be wide ranging. The proposals regarding guaranteed insurability and customer relationship assets highlight where the principles of CEV conflict with historic accounting conventions such as prohibiting the recognition of internally generated goodwill and other intangible assets.

While guaranteed insurability is one of the concepts that make insurance contracts unique from other executory contracts, the guaranteed insurability test will not

be meaningful in all circumstances in the insurance industry. Concern has been expressed by some that this concept may result in the exclusion of cash flows that market participants would otherwise include in determining a CEV for a book of insurance liabilities.

Liabilities for profit participation rights and future interest credits

Some contracts issued by insurers grant policyholders rights to receive, in addition to guaranteed benefits, benefits that are at the discretion of the insurer. Generally, these are based on the performance of a specified pool of assets of the insurer, investment returns, or the profit of a specified entity (i.e., policyholder participation rights). The IASB's preliminary view is that liabilities for future policyholder profit participation rights and for future interest credits on universal life contracts would be recognized only to the extent that the insurer has a legal or constructive obligation to transfer economic benefits (constructive obligation as defined in IAS 37).

If the terms and conditions attached to contracts with policyholder participation rights are not sufficient for the future expected payments to qualify for recognition as a liability, the amounts to be credited in the future will be included in equity until the policyholders have an unconditional claim. Many insurers and insurance regulators believe that it is misleading to include in equity amounts that are reasonably expected, but not legally or constructively obligated, to be paid to policyholders in the



future. Under US GAAP guidance in SFAS 60, SOP 95-1 and SOP 00-3, recognition of future dividends on participating contracts is either explicitly or implicitly reserved, depending on the product. However, in situations where a legal or constructive obligation cannot be proved, the preliminary view would result in gains being recognized at issue with losses recognized in later years. A similar issue arises with certain interest-sensitive products primarily sold in North America.

Credit characteristics considered in valuing a liability

The CEV model assumes that rather than being settled, a liability is transferred to a market participant at the measurement date. The IASB argues that, in principle, it is correct for the credit characteristics of a liability to be taken into account in determining its fair value, even if in practice this has a negligible effect.

The Discussion Paper noted that in a market transaction, the transferor would not willingly pay more than the market value of the liabilities to the transferee and would certainly not pay an additional amount to improve the credit characteristics inherent in the liabilities being transferred. Therefore, the IASB believes that CEV is the price for a transfer that neither improves nor impairs the credit characteristics of the liability, and that the credit characteristics should be taken into account in determining that value.

Financial performance

The Discussion Paper inquires whether premiums should be presented as revenue or as deposits. This academic question

arises from an assumption that insurance contracts are financial instruments rather than service contracts. If insurance contracts are determined to be financial instruments and premiums are considered deposits that are to be returned to the policyholder at some future date, the presentation of the income statement compared with US GAAP will radically change. Furthermore, consideration will need to be given to how claims are presented – as an expense or a return of the deposit. The question of how premiums should be recorded may be addressed initially in the IASB’s revenue recognition project rather than its insurance contracts project.

Phase II Summary

If the proposals in this Discussion Paper form the basis of a new accounting standard, they will result in a fundamental change in the finance and actuarial functions of many insurance companies. The recognition and measurement model that the Discussion Paper proposes is very different from the models currently used by many insurers around the globe. Implementing such a model and understanding its effect on systems, data, pricing, and capital management will be a major challenge.

Comments on the Discussion Paper were due on 16 November 2007. Because of the need for wide consultation, and the time allowed for the various formal steps of the standard setting process, a draft standard is unlikely to be exposed before 2009. ■

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