

IFRS PROPOSAL FOR ACCOUNTING FOR INSURANCE CONTRACTS

On 30 July 2010 the International Accounting Standards Board (IASB) released an Exposure Draft (ED) on accounting for insurance contracts. The discussion period on the ED is set to expire on 30 November 2010. It is anticipated that the new standard on accounting for insurance contracts will be issued in mid 2011 and will replace the current standard IFRS 4. The new standard is currently scheduled to be effective for accounting periods beginning on or after 1 January 2013.

DEFINITION OF INSURANCE CONTRACTS

The ED retains the definition of an insurance contract already included in IFRS 4, however, it does clarify how “significant insurance risk” should be evaluated. The definition is broad and may result in some contracts issued by non-insurance companies being subject to the standard e.g. financial guarantee contracts or loans with waiver upon death. However the ED specifically excludes “fixed fee service contracts” such as maintenance contracts.

MEASUREMENT OF INSURANCE LIABILITIES

The ED proposes two methods for measuring the liability associated with an insurance contract:

1. Building block method
2. Simplified method

Building block method

The ED indicates that insurance contracts are measured using four building blocks made up of the present value of the expected cash flows arising from the contract (fulfilment cash flows) being:

1. *Unbiased, probability-weighted average future cash flows expected to arise as insurer fulfils the obligation*

Fulfilment cash flows must be the net of those cash flows that are explicitly or directly related to the insurance contract under review. An entity must incorporate, in an unbiased way, all information about the amount, timing and uncertainty of these cash flows. The entity must consider different scenarios for the timing, amount and likelihood of cash flows and take the weighted average of these outcomes.

2. *Time value of money (discounted)*

The discount rate used to reflect the time value of money should be a risk free interest rate, adjusted for characteristics unique to the liability under review. If the liability is linked to the performance of an asset this should be reflected in the discount rate.

3. *Risk adjustment*

The risk adjustment is set to reflect the inherent uncertainty of the timing of future cash flows. There are three techniques to measure the risk adjustment:

- Confidence level
- Conditional tail expectation
- Cost of capital

4. *Residual margin*

The residual margin is calculated at the commencement of the contract and reflects the profit that would be released on day one. The residual margin is amortised over the cover period of policy. If the residual margin is in fact a loss then it should be recognised immediately. The residual margin is calculated only once and it is not recalculated at the end of each reporting period unlike the other three building blocks.

Simplified method

This method only applies to the period of cover or “pre claims period” of short term (one year or less) insurance contracts. The liability is measured as being the original premium plus the net present value of any future premiums relating to the same contract less incremental acquisition costs. The liability is amortised over the pre claims or cover period based on normal unearned premium principles such as the passage of time or claims pattern.

There is an “onerous contract test” whereby the liability under the simplified method is compared to what the liability would be under the building block method. If the liability under the building block method is greater then the additional liability is recognised.

Once the policy period has expired then the liability will be assessed using the building block method.

The logo for Willis, featuring the word "Willis" in a white, serif font on a dark blue background.

PRESENTATION

The ED requires that net insurance contract assets or liabilities and net reinsurance assets or liabilities are presented in the "Statement of financial position".

For the "Statement of comprehensive income" the following is required to be disclosed as a minimum when using the "Building block method":

1. Underwriting margin – analysed between "Change in risk adjustment" and "Release of residual margin".
2. Gains and losses at initial recognition – analysed between "Losses on portfolio transfers", "Gains on buying reinsurance" and "Day one losses" due to the liability adequacy test.
3. Non-incremental acquisition costs.
4. Experience adjustment and changes in estimates – analysed between "Experience adjustments", "Changes in cash flow estimates", "Changes in discount rates" and "Reinsurance impairment losses".
5. Interest on insurance liabilities.

For those contracts applying the Simplified Model the following would be required as a minimum

1. Premium revenue
2. Claims incurred
3. Expenses incurred
4. Incremental acquisition costs incurred.

DISCLOSURE

Under the new proposal an insurer would disclose qualitative and quantitative information about the amounts recognised in the financial statements and the nature and extent of the risk arising from the insurance contracts to help users understand the amount, timing and uncertainty of future cash flows arising from insurance contracts.

The ED requires reconciliation from the opening to the closing aggregate insurance and reinsurance balances. It also requires the disclosure of the "measurement uncertainty analysis" of the inputs that have a material effect on the liability calculated.

As well as disclosing the nature and extent of the risks arising and claims development tables (as is currently the case) the insurer will also disclose information on the regulatory framework in which the insurer operates.

GENERAL

The ED also deals with specific areas that might be of interest to some companies such as:

1. Reinsurance
2. Portfolio transfers
3. Business combination
4. Unbundling of insurance contracts

The ED also stipulates a number of transition rules which deal with the measurement of the opening insurance liabilities in the period of first time adoption of the eventual standard.

WHAT TO DO NOW?

We urge all insurers/captive insurance company owners to become familiar with the requirements of the standard and if necessary make representations on the areas of greatest concern. These representations can be made directly or through industry bodies or your captive manager

Secondly when the final standard is issued in 2011 insurers will need to assess the information required for calculation of the insurance liabilities and disclosure in the financial statements so as to amend current data capture systems to ensure the relevant information is to hand when required.

It should be noted that this will not just apply to companies that adopt IFRS. With the accounting standards convergence project continuing it is likely that UK GAAP will be "switched off" and most companies, including captives, will be required to adopt some form of IFRS. This convergence project is likely to be implemented in the same time frame as the adoption of the IFRS for insurance contracts.

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