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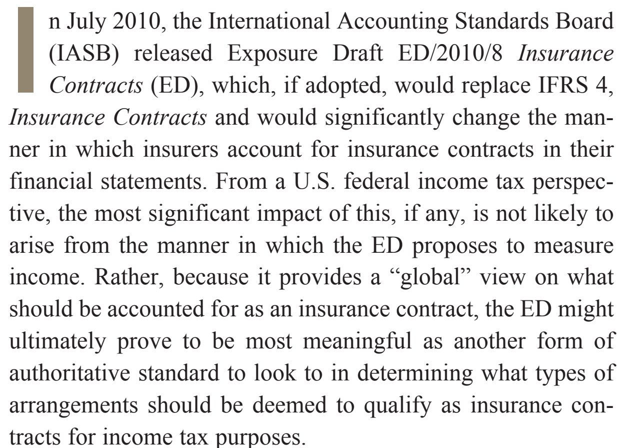

IASB EXPOSURE DRAFT ON INSURANCE CONTRACTS

By Frederic J. Gelfond and Yvonne S. Fujimoto

In July 2010, the International Accounting Standards Board (IASB) released Exposure Draft ED/2010/8 *Insurance Contracts* (ED), which, if adopted, would replace IFRS 4, *Insurance Contracts* and would significantly change the manner in which insurers account for insurance contracts in their financial statements. From a U.S. federal income tax perspective, the most significant impact of this, if any, is not likely to arise from the manner in which the ED proposes to measure income. Rather, because it provides a "global" view on what should be accounted for as an insurance contract, the ED might ultimately prove to be most meaningful as another form of authoritative standard to look to in determining what types of arrangements should be deemed to qualify as insurance contracts for income tax purposes.

The following provides a brief background on the IASB insurance contract project and an overview of the major components of the proposed new accounting standard, including the guidance it provides regarding how to define the term "insurance contract."

BACKGROUND

In 1997 the International Accounting Standards Committee, the predecessor to the IASB, established a steering committee to commence an examination of accounting standards for insurance contracts. Underlying the initiative to address the accounting treatment for insurance contracts have been concerns that current accounting practices (1) do not provide sufficient clarity regarding the economics of insurance contracts, and (2) have led to a lack of comparability among insurers and with other financial institutions. The latter is viewed to have been exacerbated by the variety of different accounting models that exist today. Hence, the overall objective of the IASB is to develop a standard that provides a consistent basis for accounting for insurance contracts; one that will make it easier for users of financial statements to understand how insurance contracts affect an insurer's financial position, financial performance and cash flows, and that also enhances the comparability of financial statements across entities, jurisdictions and capital markets.

In 2002, the IASB began a two-phase project, with Phase I culminating in 2004 with the release of International Financial Reporting Standard (IFRS) 4, *Insurance Contracts*. Because IFRS 4 was intended to be temporary, it made only limited adjustments to the accounting for insurance contracts, and permitted a variety of practices to continue, in an effort to avoid making major changes that might be subject to reversal upon the completion of the second phase of the project.

The Financial Accounting Standards Board (FASB) joined the project in October 2008. Since then, the landscape of Phase II has been rapidly evolving into a key convergence project. Discussions leading to the ED were held jointly by the IASB and the FASB and resulted in the FASB publishing the IASB's ED as the Discussion Paper, *Preliminary Views on Insurance Contracts,* (DP) in September 2010 rather than issuing its own exposure draft. The DP seeks the views of U.S. constituents on the proposed IFRS model, and to gather more information as to whether the possible new guidance provides sufficient improvement to U.S. GAAP to justify issuing new guidance.

The proposed accounting standard is intended to apply to all insurance, including reinsurance contracts—life and nonlife—that meet the definition of insurance contract set forth in the current IFRS 4. As discussed below, that definition is based on whether an arrangement involves the transfer of significant insurance risk. In addition, the proposed new accounting standard provides for a measurement model intended to focus on (1) the drivers of insurance contract profitability and current estimates of cash flows, (2) presentation of information about contracts that reflect changes in those drivers, (3) consistency in accounting for embedded options and guarantees in insurance contracts and the unbundling, in general, of items that are not closely related to the insurance coverage, (4) usage of consistent financial market inputs, such as interest rates, and (5) a framework for dealing with more complex insurance contracts, including those that are yet to be developed.

While the IASB and FASB reached common ground on many areas, there are some areas in which they reached different conclusions. The primary area of tension between the IASB and

FASB relates to the proposal in the ED for insurance liabilities to be measured on a current value basis with maximum use of market consistent inputs. That is, the ED requires insurance liabilities to be measured using a transparent building blocks accounting model based on a discounted probability-weighted estimate of future cash flows. The accounting for the volatility inherent in this probability-weighted estimate is an area upon which the IASB and FASB failed to agree during their deliberations, and resulted in the IASB seeking feedback on two different methods.

The Proposed Measurement Model

More precisely, the ED proposes that all insurance contracts be accounted for by applying a measurement model that uses a transparent building block approach. The building blocks are:

1. a probability-weighted estimate of future cash flows,
2. a discount rate to reflect the time value of money, and
3. a margin to reflect uncertainty and future profit.

The first building block is defined as a current, unbiased and probability-weighted estimate of the projected future cash flows expected to arise as the insurer fulfills the obligation under the insurance contract, *i.e.,* an expected value. The contract period includes all cash flows until the point at which the insurer can unilaterally terminate or re-underwrite (reassess the risk of the particular policyholder and re-price it to reflect fully the risk of) the contract. This is known as the contract boundary and it represents an important and innovative feature of the proposal.

Under the proposal, the insurance contract is to be recognized initially at the earlier of the date when the insurer is bound by the terms of the insurance contract (usually the signing date) or when the insurer is first exposed to risk under the contract (the effective date of the contract); it is derecognized when it no longer qualifies as a liability of the insurer.

The process to estimate the future cash flows is not based on fair value concepts; instead it is to reflect the insurer's own perspective and cover all future cash flows that are integral to the fulfillment of the insurance contract on an expected value basis (*i.e.,* probability-weighted). These cash flows would include premiums, expenses, benefits and claims payments, as well as incremental acquisition costs, and in the case of participating insurance contracts, the benefits that an insurer expects to pay to policyholders (*i.e.,* policyholder dividends). Observable market data (for example, interest rates and other market data) are to be considered in developing the estimates.

That is, the ED requires insurance liabilities to be measured using a transparent building blocks accounting model based on a discounted probability-weighted estimate of future cash flows.

This method is referred to as the "current fulfillment value" approach because it focuses on the entity's fulfillment obligations.

The second building block involves discounting of the cash flows using the discount rate that reflects the characteristics of the insurance liability—*i.e.,* its currency, duration and liquidity characteristics. The ED establishes that the discount rate is not to reflect the characteristics of the assets backing the liability, unless the amount, timing or uncertainty of the contract's cash flows depends on the performance of specific assets (*e.g.,* participating contracts). The discount rate could be estimated using a risk-free rate adjusted for an illiquidity premium. For example, a payout of a traditional immediate annuity results in highly illiquid cash flows because the policyholder cannot withdraw cash before each annuity payment becomes due or redeem the contract at will.

The above-noted difference between the IASB and FASB approaches involves the third building block,[1] the margin to reflect uncertainty and future profits. As a result of the IASB's and FASB's failure to agree on the accounting for the volatility inherent in the estimate, two different methods are discussed in the ED:

- The first method—reflective of the IASB approach—requires the uncertainty of the cash flows to be explicitly measured in a risk adjustment that insurers would calculate using one of three permitted techniques. Any accounting profit that would arise when the insurance contract is measured as the sum of the expected value and the risk adjustment is captured through a residual margin and recognized over the period of the insurance coverage.

- The alternative method prescribed by FASB avoids the explicit measurement of estimation uncertainty (*i.e.,* the risk adjustment) and, instead, captures it together with any future profit in a "composite margin" that is subsequently released to profit using a formula based on the actual cash flows paid and received compared to their expected value.

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While the above measurement model is the centerpiece of the ED, the proposed guidance covers a number of other detailed issues, full analysis of which is substantially beyond the scope of this *Taxing Times* piece. Briefly, however, among the other issues it deals with are the following:

- A simplified approach for short-term contracts that provides a shortcut method during the "pre-claim" phase for contracts with a coverage period of 12 months or less.
- Contract boundary concepts that require consideration of a contract as a single bundle of rights and obligations, thus avoiding mismatches that can occur by considering such items separately.
- Treatment of participating features as being so interdependent with the other clauses of the contract that they should be treated as a component of the contract and thus be included in the estimation of the future cash flows that the insurer will pay to its policyholders.
- The unbundling of contract components that are not closely related to the insurance coverage.
- A presentation approach that requires display on the face of the statement of comprehensive income of the key components of the building blocks model that underpin profit recognition.
- Disclosures that are more descriptive and prescriptive than IFRS 4.
- Guidelines on the treatment of reinsurance.

DEFINITION OF INSURANCE CONTRACT . . . THE REAL TAX IMPACT?

While the issuance of the ED by the IASB may be an important accounting development, the question that remains for U.S. tax professionals is: "What does the ED mean for tax purposes?" That is, in the United States, the taxation of insurance companies is based on statutory accounting, not GAAP or IFRS. As such, it appears that adoption of IFRS 4 would have a limited, or possibly no, impact on the ultimate determination of taxable income by a U.S. insurance company under current tax rules.

One circumstance where it could have an impact would be if the company has taxable income flowing into it from a foreign branch operation that is required under local law to follow IFRS and use it as a basis for determining taxable income. IFRS 4 could also have a significant impact on the measurement of deferred tax assets and liabilities reported on GAAP/IFRS financial statements. This is the result of the fact that such amounts would be determined based on a comparison of tax bases to the new IFRS bases, and would also be subject to whatever recognition standards may apply.

As noted above, however, the ED may also be important from a tax perspective as it provides another standard one could look to in seeking to establish a tax definition of insurance contract. That is, the Internal Revenue Code[2] does not define the term "insurance." That task has been left, for the most part, to the courts, and has resulted in an evolving framework for determining the existence of insurance for federal income tax purposes. The Internal Revenue Service (IRS) has also provided its insights over the years as to what will qualify as insurance,[3] but, nevertheless, the definition of insurance continues to be a regular matter of controversy.

Although the IRS has never formally accepted an accounting definition of insurance as establishing the standard for governing the tax characterization of an arrangement, there are times when it has looked to the accounting standards as providing relevant guidance.[4] For example, it has looked to ASC 944-20-15-41 (formerly part of FAS 113) to determine the existence of an insurance risk based on a reasonable possibility of a significant loss by the insurer under an arrangement. The ED includes similar concepts in its definition, which is based on the transfer of significant insurance risk to the insurer.

The ED defines the term "insurance contract" as:

> A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

It further defines the term "insurance risk" to mean, "[r]isk, other than financial risk, transferred from the holder of a contract, to the issuer," and defines an insured event as, "[a]n uncertain future event that is covered by an insurance contract and creates insurance risk."

While each of these terms has resulted in a fair amount of discussion in the tax arena over the years, the ED provides a substantial amount of guidance on how to apply these terms, including what will be deemed to be an uncertain future event for IFRS accounting purposes. First it analogizes the terms "uncertainty" and "risk," and provides that "uncertainty (or risk) is the essence of an insurance contract." The ED then states that, "at least one of the following is uncertain at the inception of an insurance contract:

> (a) whether an insured event will occur;

(b) when it will occur; or
(c) how much the insurer will need to pay if it occurs."

It then explains that an insured event can be the discovery of a loss during the term of a contract, even if the loss occurred before the inception of the contract, while in other contracts, the insured event is an event that occurs during the term of the contract even if the loss is discovered after the contract terminates. The ED then elaborates that an insurance contract can cover events that have already occurred—and be known to have occurred—but whose financial effect is still uncertain. Under those contracts, it explains, the insured event is the discovery of the ultimate cost of those claims.

The above definition of insurance actually first appeared in IFRS 4 Phase I, which focused on the introduction of a workable definition of insurance contracts that is reflective of national accounting practices under IFRSs. This definition proved to be effective and, therefore, the ED introduced only two limited refinements.

The first introduces the requirement to use present values to assess whether insurance risk is significant. The second relates to the requirement that the scenarios considered in assessing whether the insurance risk is significant have commercial substance. To have commercial substance, the scenario must be capable of producing a loss for the insurer after considering all the inflows it may receive from the contract. Both of these clarifications have been added to facilitate the FASB's moving to adopt the IFRS's insurance contract definition.

Whether the IRS is able to apply this type of standard in determining whether an arrangement is an insurance contract remains to be seen. Nevertheless, the ED definition establishes a uniform basis upon which authorities around the world may conduct this analysis.

EFFECTIVE DATE

The ED was open for comments until Nov. 30, 2010, with an initial goal of issuing a final standard in June 2011 that has now been pushed back to December 2011. It is expected that the effective date would be aligned with the mandatory application of IFRS 9, *Financial Instruments* (currently Jan. 1, 2013). Consideration will be given to delaying the effective date of IFRS 9 if the IFRS on insurance contracts has a mandatory effective date later than Jan. 1, 2013.

CONCLUSION

The revisions to IFRS 4 reflected in the ED were significant, and it will be interesting to see what changes come about as a result of comments submitted to the IASB and FASB. From a tax perspective, it will be even more interesting to see if the ED, in either its current or final form as new IFRS 4, could have an impact on how the term "insurance contract" is looked at for federal income tax purposes.

END NOTES

1 Under the IASB approach, it is actually the third and fourth building blocks. As discussed in the text, the FASB approach uses a composite margin to capture both elements and, hence, involves only three building blocks.
2 Internal Revenue Code of 1986, as amended.
3 *See, e.g.*, Rev. Rul. 2007-47, 2007-2 C.B. 127, and Rev. Rul. 89-96, 1989-33 I.R.B. 9 involving insurance risk; Rev. Rul. 2002-89, 2002-52 I.R.B. 984, Rev. Rul. 2002-90, 2002-52 I.R.B. 985, and Rev. Rul. 2002-91, 2002-52 I.R.B. 991, and Rev. Rul. 2005-40, 2005-24 I.R.B. 4, discussing risk shifting and risk distribution.
4 *See, e.g.*, 1997 FSA 708.

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Frederic J. Gelfond is a principal with the Washington, D.C. National Tax office of Deloitte Tax LLP and may be reached at *fgelfond@deloitte.com*.

Yvonne S. Fujimoto is an insurance tax senior manager with the Washington, D.C. National Tax office of Deloitte Tax LLP and may be reached at *yfujimoto@deloitte.com*.