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International Accounting Standards—Phase I is "Finished"

by Doug Doll and Peter Wright

Introduction

The process of developing international accounting standards for insurance contracts has been long and arduous. There have been numerous articles detailing the deliberations to date. For a good summary of background and considerations, we recommend the articles in the February 2004 issue of *The Actuary*, available on the SOA's Web site.

The European Union has stated that, beginning in 2005, public companies must report their earnings using international financial reporting standards (IFRS) adopted by the International Accounting Standards Board (IASB), provided that these have been endorsed by the European Union. IFRS is needed for insurance contracts, but the 2005 deadline proved impossible to meet, so the project was divided into Phase I and Phase II, where Phase I is a temporary measure until Phase II can be completed. An exposure draft (ED5) was issued July 2003, with proposed Phase I rules. Some of these were controversial, and changes have been made during the past few months.

The IASB published its IFRS 4 on March 31, 2004, which, in theory, completed Phase I of its insurance project. The IASB also published a Basis for Conclusions and Implementation Guidance which covers the following:

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- Examples of what is, and is not, an insurance contract
- Examples of embedded derivatives and whether these have to be accounted for at fair value in accordance with IAS 39, which covers financial assets and liabilities
- How to unbundle the deposit component of a financial reinsurance contract
- Shadow accounting, which allows for some relief from the mismatch caused by inconsistent accounting between assets and liabilities
- Examples of the types of detailed disclosure that may be required

In an accompanying press release, the IASB announced its intention to establish an international working party of around 15 members drawn from the insurance industry, the accounting profession, supervisory authorities and investment analysts. The primary role of this working party will be to assist the IASB in the second phase of the insurance project, but the IASB indicates that it may be willing to revise IFRS 4 in the short term "in the light of any immediate solutions arising from the working party's discussions."

As yet, the IASB's standards on financial instruments (IAS 32 and 39) have not been endorsed by the European Union even though the revised versions, issued in December 2003, met many of the banks' objections regarding hedge accounting. It is possible that IFRS 4 may not be endorsed, as some continental countries are known to be unhappy at the IASB's solution to the asset/liability mismatch issues described below. It is not clear whether the whole European project to adopt the IASB's standards can continue if all the standards are not endorsed.

Main features of IFRS 4 Definition of an Insurance Contract

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.

Insurance Risk—Risk, other than financial risk, transferred from the holder of a contract to the insurer.

There are some exclusions, but these are not relevant to insurance companies. The definitions are applied on an individual contract basis. This test is applied at outset, and once a contract is designated as insurance, it remains so throughout its life.

The importance attached to the definition of an insurance contract arises from the fact that the accounting treatment of a financial instrument may differ from an insurance contract. The definition of a financial instrument in IAS 32 and 39 will, in turn, exclude from its scope insurance contract as defined above.

The difficult aspect of the definition is clearly what constitutes "significant" insurance risk. It seems likely that this will not be a problem for most general insurance products, other than possibly financial reinsurance arrangements and some heavily experience-rated schemes. The inclusion of a surrender penalty, waived on death, is insufficient to justify classification as an insurance contract.

Exemption from Paragraphs five and six of IAS 8

Paragraphs five and six of IAS 8 set out a hierarchy of sources for selection of an accounting policy in the absence of an IAS/IFRS. IFRS 4 gives insurance companies an exemption from applying this hierarchy.

The general exemption from applying paragraphs five and six of IAS 8 comes at the cost of certain specific rules which the IASB deems to flow from these paragraphs.

- Catastrophe and equalization provisions should not be recognized.

- A liability adequacy test should apply (on a block of business basis) to the insurance liabilities less any deferred acquisition cost asset.
- An insurance liability shall be derecognized only when it is extinguished.
- Reinsurance should not be netted off against obligations to direct policyholders.

Embedded Derivatives

Under IAS 39, embedded derivatives that are not closely related to a host contract have to be separated out and accounted at fair value with movements in fair value going through the income statement. An exception to this rule applies if the whole contract is already valued on this basis. This requirement is not restricted to financial instruments and, hence, applies to derivatives embedded in insurance contracts, too.

Phase I gives an exemption to embedded derivatives that are themselves insurance contracts. This exempts, for example, guaranteed annuity options, and for this type of exemption, enhanced disclosure requirements apply. Phase I also exempts from this requirement a policyholder's option to surrender a policy for a fixed amount or an amount based on an interest rate.

Accounting for Reinsurance

The IASB is concerned at the possibility that reinsurance may be used to manipulate reported results. An earlier proposal, which prohibited the reporting of income at the inception of a reinsurance treaty, has been replaced by a requirement to disclose the extent of any such profit taken.

Asset/Liability Accounting Mismatch

The IASB made a number of last-minute changes to try to accommodate concerns that earlier proposals could force an artificial asset/liability mismatch arising from the adoption of IAS 39 for asset valuations. IAS 39 is similar to FAS 115 in that only assets satisfying strict "held to maturity" rules are held at book value.

Some countries' accounting bases adopt a "locked-in" valuation rate of interest for liabilities aligned to the use of historical or amortized cost for assets. In other cases, policyholder liabilities under with-profits (participating) contracts differ as to whether gains are realized or unrealized. This can cause a mismatch in the balance sheet where assets are classified as available for sale and, hence, reported at market value in the balance sheet.
The changes include:

- Making it permissible to unlock a valuation rate of interest for the purposes of assessing liabilities for particular blocks of business. This will solve the first problem referred to above if companies are willing to value backing assets at fair value and put changes in fair value through the income statement. An available "for sale" classification would still result in a mismatch arising in the income statement.
- Shadow accounting is made permissible, whereby liabilities can be revalued in the balance sheet as if all unrealized gains were realized. This is aimed at resolving the second problem referred to above.

Disclosure Requirements

The disclosure requirements for Phase I were amongst the most controversial and onerous requirements of previous drafts.

Disclosure is based around two high-level principles:

- Explanation of recognized amounts
  "An insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts."
- Amount, timing and uncertainty of cash flows
  "An insurer shall disclose information that helps users to understand the amount, timing and uncertainty of future cashflows from insurance contracts."

It was explained in ED5 that these principles, in addition to supporting implementation guidance, were considered to be a better approach than prescribing a long list of detailed disclosures. In response to comments that the required disclosures are onerous and proprietary, the IASB has added guidance to the effect that an insurer should not typically have to disclose all the information suggested in the guidance in order to satisfy high-level principles. Furthermore, the guidance does not create additional requirements and an insurer must decide, in the context of its circumstances, how much detail it needs to disclose in order to meet the requirements. Nevertheless, the guidance, at 61 paragraphs, remains very extensive.

In order to satisfy the first principle, companies will need to disclose:

- Accounting policies
- Assets, liabilities, income and expense arising from insurance contracts
- The process used to determine material assumptions and, where practicable, the actual assumptions
- The sensitivity of results to changes in assumptions
- Material changes in insurance liabilities, reinsurance assets and deferred acquisition costs.

Disclosure of assumptions is clearly essential to any proper understanding of the financial statements. The guidance recognizes that, while disclosure of

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some assumptions such as discount rates and future inflation will be straightforward, full disclosure of, for example, mortality or persistency assumptions is not practicable. For these assumptions it emphasizes disclosure of the process used to generate the assumptions. This should include disclosure as to whether assumptions are intended to be best estimates or to include margins, the extent to which they are derived from actual company data rather than industry data and how they relate to actual experience.

The second principle will require disclosure of:

- Risk management policies and processes
- Terms and conditions of insurance contracts that have a material effect on future cash flows
- Information on insurance risk, including claims development data for general insurance
- Information on interest rate risk and credit risk comparable with the disclosure requirements of IAS 32
- Information on exposures to interest rate risk and market risk under embedded derivatives not measured at fair market.

The requirement to disclose the terms and conditions of policies is likely to be controversial. The guidance suggests disclosure, by each broad class of insurance liabilities and reinsurance assets, of:

- The nature of the risk covered
- Concentration of risk and any factors mitigating those risks
- Claims development data
- The basis for determining investment returns credited to policyholders
- The general nature of any participation features, including the extent of any discretion held by the insurer.

It is also suggested that insurers disclose information analyzing insurance liabilities and reinsurance assets by the period in which net cash flows are expected, as well as a description as to how these would change if policyholders exercised lapse or surrender options in different ways.

Claims development data is required for the period going back to the earlier year for which material incurred claims are still outstanding but need not go back more than 10 years (or five years before the end of the first financial year in which IFRS 4 is applied). There is an exemption from this requirement, subject to disclosure, if it is not practicable to prepare data about claims development occurring prior to the period for which full comparative information complying with IFRS 4 is prepared.

It will not be a requirement to disclose comparative data in accordance with IFRS 4 for years beginning before January 1, 2005, except for accounting policies and recognized assets, liabilities, income and expense.

Outlook for Phase II

The IASB will now turn its attention to Phase II of the insurance project. In January 2003, the board reached tentative conclusions regarding Phase II of the project, including the following:

- The general approach should be one of "fair values" rather than deferral and matching.
- Assumptions used for setting provisions can be entity specific, when market-based information is not available without undue cost and effort.
- The interpretation of "fair value" should be to an "entry" rather than the more usual prospective "exit" value. This has the implication that "a policy issuer would not recognize a net gain at inception of an insurance contract" unless its own premium rates or policy charges are demonstrably higher than the market rates.
- Except where policyholder liabilities are directly dependent upon investment returns from a defined asset pool, discounting should be at a "risk-free" rate rather than a rate that has regard to backing assets.
- Fair value should incorporate "market value margins." This is a difficult area to define.
- Future premiums should be recognized only if (a) policyholders hold uncancellable continuation or renewal rights that restrain the ability of the insurer to reprice the contract and (b) those rights will lapse if policyholders stop paying premiums.
- Fair values should reflect the credit standing of the insurance company. The IASB did, however, state that the allowance for credit standing should reflect the existence of policyholder protection schemes, although the logic for this is not entirely clear.

At its November 2003 meeting, the IASB agreed to revisit all of these conclusions and also the rule in IAS 39 that liabilities must be no less than any amount payable on demand. It is to be hoped that the board does indeed look again at these with an open mind, although the use of an entry approach to fair value and the demand deposit feature do seem to be well engrained in the IASB's thinking. ☐