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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **24 May 2006, London**

Project: **Insurance contracts (phase II) (Agenda Papers 4D, 4E, 4F)**

AGENDA PAPER 4D
REINSURANCE

Purpose of this paper

1. This paper discuss reinsurance assumed (inwards reinsurance) and reinsurance ceded (outwards reinsurance). It also notes briefly an implication for policyholder accounting.

Summary of recommendations

2. This paper recommends the following:

   (a) The measurement attribute for reinsurance assumed (inwards reinsurance) should be current exit value (paragraphs 7-8).

   (b) The measurement attribute for reinsurance assets (outwards reinsurance) should be current exit value (paragraph 11).

   (c) For risks associated with the underlying insurance contract, a risk adjustment typically:

      (i) increases the measurement of the reinsurance asset.

      (ii) is equal in amount to the risk adjustment for the corresponding portion of the underlying insurance contract. (paragraphs 12-17)

(d) The conclusion on risk adjustments for reinsurance assets may also be relevant for policyholder accounting. The Board will consider policyholder accounting after the discussion paper stage (paragraph 18).

(e) The carrying amount of reinsurance assets should be reduced by the expected (probability-weighted) present value of losses from default or disputes, with a further reduction for the margin that market participants would require to compensate them for bearing the risk that defaults or disputes exceed expected value (expected loss model). (paragraphs 19-23)

(f) Given the Board's tentative decision to use current exit value as the measurement attribute for insurance contracts, there is no need for specific restrictions to prevent the recognition of misleading gains or losses when an insurer buys reinsurance. (paragraphs 24-28)

(g) A cedant should recognise at current exit value its contractual right, if any, to obtain reinsurance for contracts that it has not yet issued. In practice, that current exit value may not be material in many cases. (paragraphs 29-31)

Background

3. IFRS 4:

(a) defines a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.

(b) uses the term 'reinsurance asset' to describe the cedant's net contractual rights under the reinsurance contract.

4. Insurers typically buy reinsurance for one or more of the following reasons:

(a) To provide protection against catastrophic losses.

(b) To reduce the amount of required regulatory capital.

(c) To reduce volatility.

(d) To benefit from cost advantages that reinsurers may face, such as different regulatory requirements or economies of scale.

(e) To benefit from technical support provided by the reinsurer.

5. There are several forms of reinsurance, such as:

   (a) Proportional (or quota share): the reinsurer takes a fixed proportion of all contractual cash flows.

   (b) Non-proportional: the reinsurer covers losses within specified limits or layers (eg stop loss)

   (c) Treaty (which could be proportional or non-proportional): the reinsurer commits to cover all contracts issued within a specified period that meet specified critieria.

   (d) Aggregate: the reinsurer pays claims that exceed claims that exceed specified limits across several contracts, or types of cover (eg total claims on motor or household contracts exceeding CU X in total)

   (e) Financial reinsurance: contracts that do not transfer significant insurance risk or have significant financial components

6. Reinsurance often differs in some respects from direct insurance:

   (a) The reinsurer has no direct relationship with the underlying policyholder(s). Consequently, the reinsurer may have less detailed information than the cedant about the characteristics of the portfolio.

   (b) There may be time lags before the reinsurer receives information from the cedant. The information may not be accurate or complete, and may lack detail.

   (c) By collating information from a range of cedants the reinsurer may be in a position to detect some overall market trends earlier than individual cedants.

   (d) Although complex features such as stop loss features and multi-line or multi-year features exist in direct insurance (particularly in commercial lines), these features may be more prevalent in reinsurance. Also, reinsurance contracts may be more likely to be customised.

   (e) In general, reinsurance contracts are larger than many (though not all) direct insurance contracts.

   (f) The reinsurer may be subject to different regulatory requirements, including different capital requirements.

(g) The reinsurer may be able to diversify risks across a broader pool. Among other things, this is likely to mean that the reinsurer's unit of account differs from the cedant's unit of account.

Reinsurance assumed (inwards reinsurance)

7. For reinsurance assumed, the staff has identified no specific issues to address at this stage of the project. The staff sees no reason why the accounting approaches developed for direct insurance should not also work for reinsurance assumed. The staff recommends current exit value as the measurement attribute for reinsurance assumed.

8. Even if the cedant and reinsurer both use the same measurement attribute for their contractual rights and obligations, that does not necessarily mean that they will determine the same amount (ie there is no 'mirror accounting'). Possible reasons for differences include different knowledge and different units of account.

Reinsurance ceded (outwards reinsurance)

9. This paper discusses the following aspects of reinsurance ceded:

   (a) Adjustments for the risk associated with the underlying insurance contracts (paragraphs 12-18)

   (b) Impairment (paragraphs 19-23)

   (c) Gains and losses on buying reinsurance (paragraphs 24-28)

   (d) Non-overlapping periods of coverage (paragraphs 29-31)

10. This paper does not address the following points, as the staff believes that the Discussion Paper does not need to analyse them.

    (a) Derecognition: insurance liabilities are not derecognised until the contractual obligations are extinguished (by discharge, cancellation or expiry).[1]

    (b) Reinsurance assets are not offset against related insurance liabilities (and reinsurance income and expense are not offset against related insurance expense and income).[2]

    (c) The staff does not intend to develop specific guidance on risk transfer in reinsurance contracts. Instead, we will continue to relay on generic guidance on risk transfer in all

[1] IFRS 4, paragraph 14(c)
[2] IFRS 4, paragraph 14(d)

insurance contracts. As noted in agenda paper 4E, the staff will monitor developments in the FASB's project that is reviewing US GAAP guidance on risk transfer.

(d) The Board decided in April that it should not require insurers to unbundle deposit and service components of insurance contracts for the purpose of recognition and measurement. That conclusion is also relevant for reinsurance contracts (subject to developments in the FASB's project on risk transfer).

Reinsurance assets: Measurement attribute

11. The Board has not yet discussed the measurement attribute for reinsurance assets. Given that the Board has adopted current exit value for the underlying direct insurance liability, the staff recommends that current exit value should also be the measurement attribute for reinsurance assets.

Reinsurance assets: Risk adjustments

12. Risk adjustments for reinsurance assets have two sources:

(a) adjustments for risk associated with the underlying insurance contract (discussed in paragraphs 13-18).

(b) adjustments associated with the risk that the reinsurer will not perform its obligations (paragraphs 19-23)

13. In general, risk adjustments for an asset reduce the value of the asset. However, for reinsurance assets, that may not be the case for adjustments reflecting the risk associated with the underlying insurance contract. Example 1 addresses this point.

Example 1

Insurer A has an insurance liability with expected (ie probability weighted) cash outflows of 100. Insurer A measures the liability at 120 (ie expected cash outflows of 100 plus a risk adjustment of 20). For simplicity, time value of money is ignored. Insurer A pays a premium of 36 to reinsure 30% of the liability on a proportionate basis.

It seems appropriate for Insurer A to measure its reinsurance asset initially at 36 (ie expected value of 30 **plus** risk adjustment of 6).

Example 1 addresses simple proportional reinsurance, but similar principles would also be appropriate for more complex reinsurance coverage (eg stop loss contracts). In other

words, the risk adjustment for the reinsurance asset would be equal in amount to the risk adjustment for the corresponding portion of the underlying insurance contract.

14. It is not surprising that the reinsurer charges more than expected value to obtain an acceptable profit margin. But why would a risk-averse entity pay **more** than the expected value for an asset? The reason is that the reinsurance contract pays out precisely when the cedant most needs the money, ie when it has just suffered a large loss.

15. A reinsurance contract will pay out only if the cedant has suffered a loss caused by an insured event covered by the reinsurance contract. Therefore:

    (a) a cedant's rights under the contract typically have value only for the cedant. A cedant could not transfer those rights to a third party unless the cedant simultaneously transfers to the same party its contractual rights and obligations flowing from the underlying insurance contract.[3]

    (b) the reinsurance contract would not pay out if the cedant has not suffered a loss. Hence, if a cedant transferred the underlying contracts, it would also want to transfer the reinsurance contracts at the same time, because otherwise the reinsurance contract would have no value.

16. It follows that the current exit value for the reinsurance asset must be based on a (generally hypothetical) transaction that involves the simultaneous transfer of both the reinsurance contract and the related underling contract(s).

Staff recommendation

17. For risks associated with the underlying insurance contract, the above discussion implies that a risk adjustment typically:

    (a) increases the measurement of the reinsurance asset.

    (b) is equal in amount to the risk adjustment for the corresponding portion of the underlying insurance contract.

Implications for policyholder accounting

18. The project plan discussed by the Board in January 2005 indicated that the discussion paper will not address policyholder accounting for direct insurance contracts, and that we

[3] A transfer of the rights and obligations under the underlying contract typically requires the consent of the policyholder, regulator or both.

will address policyholder accounting after the discussion paper stage. However, looking ahead, the above discussion may also be relevant for policyholder accounting. In particular, risk adjustments mean that the policyholder's contractual rights are worth **more** to the insurer than their expected value (before consideration of impairment). Also, those contractual rights have little or no value to potential transferees who do not have the underlying insurable interest and so could not enforce the rights. These factors may be relevant when the time comes to develop a measurement model for policyholder accounting.

Reinsurance assets: Impairment

19. A cedant faces the risk that the reinsurer may default, or may dispute whether a valid claim exists for an insured event. There are two possible approaches to this risk:

    (a) Expected loss model: reduce the carrying amount for expected (probability-weighted) losses from default or disputes, with a further reduction to reflect the risk that defaults or disputes exceed expected value.

    (b) Incurred loss model: losses should be recognised only when an event, occurring after initial recognition of an asset, provides objective evidence that the asset is impaired.

20. IFRS 4 adopts an incurred loss model for reinsurance assets. Paragraph 20 of IFRS 4 states:

> If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A reinsurance asset is impaired if, and only if:
> (a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and
> (b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

21. Proponents of an incurred loss model argue that it:

    (a) provides more objectivity than an expected loss model.

    (b) is consistent with IAS 39, which adopts this model for impairment of financial assets.

22. Proponents of an expected loss model argue that:

(a) it is consistent with a measurement model that starts with the expected present value of cash flows, and is, in particular consistent with the use of current exit value as the measurement attribute.

(b) the Board's main objectives in requiring the incurred loss model in IFRS 4 were to achieve consistency with IAS 39 in a context where most measurements of the underlying insurance liabilities were not in a full current value framework. That context is no longer relevant in phase II, given the Board's preference for current value models.

Staff recommendation

23. The carrying amount of reinsurance assets should be reduced by the expected (probability-weighted) present value of losses from default or disputes, with a further reduction for the margin that market participants would require to compensate them for bearing the risk that defaults or disputes exceed expected value (expected loss model). This is consistent with the use of current exit value as the measurement attribute.

Gains and losses on buying reinsurance

24. National accounting requirements often try to address a concern that reported profit might be distorted by the timing of the decision to buy reinsurance. One source of such distortions is the failure to discount many non-life insurance claims liabilities. If the insurer buys reinsurance, the premium paid to the reinsurer reflects the present value of the liability and is, therefore, less than the previous carrying amount of the liability. Reporting a gain on buying the reinsurance is not representationally faithful if no economic gain occurred at that time. The accounting gain arises largely because of the failure to use discounting for the underlying liability. Similar problems arise if the underlying insurance liability is measured with excessive prudence.

25. Such distortions are a particular concern if contracts have the legal form of reinsurance but do not transfer significant insurance risk (sometimes known as financial reinsurance). IFRS 4 addresses some of these concerns through the definition of insurance contracts and reinsurance contracts, and through the unbundling requirements.

26. ED 5, the Exposure Draft that preceded IFRS 4, contained proposals that would have limited the recognition of gains when an insurer buys reinsurance. However, respondents generally opposed this proposal, on the following grounds:

(a) The proposals would have been difficult to apply to more complex reinsurance contracts, including excess of loss contracts and contracts that reinsure different layers of a portfolio of underlying direct insurance contracts.

(c) The proposals would have created inconsistencies with the measurement of the underlying direct insurance contracts.

(d) The artificial gain recognised at inception of some reinsurance contracts mitigates an artificial loss that arose earlier from excessive prudence or lack of discounting. If the net exposure has been reduced by reinsurance, there is no reason to continue to overstate the original liability.

(e) Any restrictions should be targeted more precisely at financial reinsurance transactions (ie transactions that do not meet the definition of an insurance contract or that have significant financial components) or contracts that provide retroactive cover (ie contracts covering events that have already occurred).

(f) A liability adequacy test and unbundling provide sufficient safeguards against the recognition of excessive profits.

27. In finalising IFRS 4, the Board deleted the proposal in ED 5 and replaced it with a specific requirement to disclose gains and losses that arise on buying reinsurance.[4]

Staff recommendation

28. Given the Board's tentative decision to use current exit value as the measurement attribute for insurance contracts, there is no need for specific restrictions to prevent the recognition of misleading gains or losses when an insurer buys reinsurance.

Non-overlapping periods of coverage

29. A reinsurance contract may not cover the same period as the underlying contract. For example, suppose a proportional reinsurance contract running covers 30% of each direct contract issued in a calendar year and meeting specified criteria. At 1 July, the cedant may still expect to issue further direct contracts during the rest of the year and has a contractual right (if the contract is not cancellable) to obtain reinsurance. That contractual right presumably has some value to the cedant, and current exit value would reflect that value, even though the new contracts to be issued do not yet qualify for recognition.

[4] IFRS 4, paragraph 37(b)

30. In general, a reinsurer would require a cedant to retain a significant portion of the underlying risk so that the cedant has an incentive to issue new contracts at an acceptable price. Therefore, the current exit value of the cedant's contractual right to obtain cover for new contracts may not be material in many cases.

Staff recommendation

31. A cedant should recognise at current exit value its contractual right, if any, to obtain reinsurance for contracts that it has not yet issued. In practice, that current exit value may not be material in many cases.

AGENDA PAPER 4E
UPDATE ON RELEVANT FASB PROJECTS

Purpose of this paper

1. This paper summarises developments in FASB projects relating to the following aspects of accounting for insurance contracts:

   (a) Risk transfer (paragraphs 3-11)

   (b) Financial guarantee contracts (paragraphs 12-15)

   (c) Life settlements (paragraphs 16-21)

   (d) Emerging Issues Task Force – Insurance issues (paragraphs 22-28)

Summary of recommendations

2. This paper concludes the following:

   (a) The FASB's work on insurance risk transfer is unlikely to require changes to the IASB's decision (in April), that phase II should not require insurers to unbundle deposit and service components of insurance contracts for the purpose of recognition and measurement. The staff will consider after this meeting whether unbundling should be prohibited in some or all cases. (paragraphs 3-9)

   (b) The IASB should not consider the following issues until after the Discussion Paper stage, when the Board will have the benefit of input from constituents and of the FASB's work on risk transfer and on financial guarantee contracts:

      (i) whether unbundling is appropriate if some or all premiums are presented as revenue (paragraph 10).

      (ii) the definition of an insurance contract (paragraph 11).

      (iii) whether the accounting model being developed for insurance contracts in general is also appropriate for financial guarantee contracts that meet the definition of an insurance contract (paragraphs 12-15).

      (iv) policyholder accounting (paragraphs 16-21 and 11(b), and the two EITF issues summarised in paragraphs 22-28).

Risk transfer

3. Under both US GAAP and IFRSs, a contract is treated as:

   (a) an insurance contract if it transfers significant insurance risk.

   (b) a financial instrument if it does not transfer significant insurance risk.

4. The FASB decided in April 2005 to begin a project to clarify what constitutes transfer of significant insurance risk. The project is intended to respond to concerns about the use of insurance or reinsurance accounting for contracts that contain significant (and, perhaps, predominant) deposit components. The project will address the accounting for both buyers and sellers of insurance and reinsurance contracts.

5. The FASB has tentatively decided:

   (a) to issue an Invitation to Comment—a neutral staff discussion document—soliciting constituent feedback on approaches that would bifurcate (unbundle) insurance and reinsurance contracts into financing and insurance components. The Invitation to Comment is scheduled for issuance in the second quarter of 2006.

   (b) to adopt draft working definitions of insurance terms and related guidance based on those in IFRS 4, with some modifications.

6. Other areas remaining to be explored in the FASB project include:

   (a) Display and disclosure requirements for risk transferred by:

      (i) insurance contracts held by non-insurance policyholders, and

      (ii) insurance and reinsurance contracts held or issued by insurance or reinsurance entities.

   (b) Clarification of current risk transfer guidance as well as the applicability of that guidance to insurance contracts (including non-insurer policyholders).

IASB Staff comment

7. The following table summarises concerns that are sometimes expressed about the use of insurance accounting for a contract that does not transfer significant insurance risk (or for a deposit component of an insurance contract). The table also summarises the extent to which IFRS 4 deals with these concerns and indicates possible implications for phase II of the IASB's project on insurance contracts.

Concern	*Effect of IFRS 4 and of proposals for phase II*
1. On buying reinsurance, a cedant might recognise an accounting gain that does not correspond to an economic gain: o if the underlying insurance liability is measured on a conservative basis and the cedant derecognises the liability when it buys reinsurance, or o if the measurement basis for the reinsurance asset differs from the basis used for the underlying insurance liability.	The following should eliminate this concern: o No derecognition of insurance liabilities until they expire or are extinguished (required by IFRS 4, no change proposed for phase II) o No offset of reinsurance assets against the underlying liability (requirement in IFRS 4, no change proposed for phase II) o Using current exit value as the measurement attribute for the liability (proposed for phase II). Among other things, because current exit value reflects the time value of money, it would eliminate the most common source of possible 'uneconomic' accounting gains for non-life claims liabilities.
2. Suppose that a contract requires an insurer to pay claims if an insured event occurs, but the claims payments leads to premium adjustments or other future payments from the policyholder to the insurer. Some existing accounting models might permit the policyholder to recognise the claims receipt as income without recognising the liability to make the resulting additional payments.	o IFRS 4 requires a cedant to unbundle the deposit component in these cases. o That requirement does not apply to policyholders, because policyholder accounting is scoped out of IFRS 4. However, policyholders are subject to the 'hierarchy' in IAS 8, which prescribes how an entity should develop an accounting policy if no specific requirement applies. o For phase II, a measurement at current exit value, or any similar basis, would include the obligation to make the additional payments.

Concern	*Effect of IFRS 4 and of proposals for phase II*
3. If deposit liabilities are classified as insurance liabilities, a cedant could manipulate commonly used ratios, such as premiums to claims liabilities or claims expense to claims liability.	○ IFRS 4 requires disclosures about insurance risk. These might help to some extent. ○ Agenda paper 4I discusses what components of income and expense should be reported by an insurer. A format that reports premiums receipts as deposits, rather than revenue, would reduce the pressure on the distinction between insurance contracts and deposits.

IASB Staff recommendation

8. In April, the IASB decided that it should not require insurers to unbundle deposit and service components of insurance contracts for the purpose of recognition and measurement. In the staff's view, for reasons given in the above table, there is unlikely to be any reason to change that conclusion as a result of the FASB's work on bifurcation. Adopting a current exit value approach would eliminate much or all of the perceived need to unbundle insurance contracts into insurance and deposit components.

9. In April, the IASB also instructed the staff to investigate whether unbundling should be prohibited in some or all cases. The staff will consider this point after the May Board meeting.

10. Unbundling might also be relevant for presentation of income and expense. Agenda paper 4I asks, among other things, whether an insurer should recognise premiums always as revenue, always as deposit receipts, or sometimes as revenue and sometimes as deposit receipts. If all premiums are presented as deposits, there would be no reason to require unbundling for presentation purposes. If some or all premiums are presented as revenue, it might be appropriate to consider unbundling for presentation purposes. However, the staff recommends that the IASB should not consider this question until after the Discussion Paper stage, when the Board will have the benefit of responses to the Discussion Paper and of the FASB's work on bifurcation.

11. The IASB staff recommends that the IASB should not review the following until after the Discussion Paper stage, when the Board can benefit from the FASB's work on risk transfer:

    (a) the definition of an insurance contract.

    (b) whether policyholders should be required to unbundle insurance contracts they hold.

Financial guarantee contracts

12. The FASB is expects to issue in the third quarter of 2006 an FASB staff position (FSP) on the timing of claim liability recognition, premium recognition, and the related amortisation of deferred policy acquisition costs, for financial guarantee contracts issued by insurance companies that are not accounted for as derivative contracts under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. A financial guarantee contract guarantees the holder of a financial obligation the full and timely payment of principal and interest when due and is typically issued in conjunction with municipal bond offerings and certain structured finance transactions.

13. The FASB will consider whether insurance companies should account for their obligations under such contracts using the short duration model in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, the long duration model in Statement 60 or some other model. The FASB will also examine the accounting for other insurance products with similar characteristics, such as mortgage guarantee contracts and credit insurance.

IASB Staff comment

14. Financial guarantees typically meet the definition of an insurance contract in IFRS 4. In 2005, the IASB issued an amendment to IFRS 4 and IAS 39 in respect of financial guarantee contracts. In developing the amendment, the Board noted that when credit insurers issue credit insurance contracts, they typically recognise a liability measured as either the premium received or an estimate of the expected losses. However, the Board was concerned that some other issuers of financial guarantee contracts might argue that no recognisable liability existed at inception. To provide a temporary solution that balances these competing concerns, the amendment requires the following:

    (a) If the issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to

insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts.

(b) In all other cases, the issuer of a financial guarantee contract should apply IAS 39. When IAS 39 applies, the issuer measures the contract initially at fair value, and subsequently at the higher of the amount determined under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less, when appropriate, cumulative amortisation recognised under IAS 18 *Revenue*.

IASB Staff recommendation

15. The Board's conclusions to date for insurance contracts in general might remove the need to scope some financial guarantees into IAS 39. The Board will be better placed to assess whether that is the case when the Board has reviewed the comment letters on the Discussion Paper on insurance contracts and when the FASB's work on financial guarantee contracts is more advanced. The IASB staff recommends that the IASB should not examine the accounting model for financial guarantee contracts until after the Discussion Paper stage.

Life settlements

16. In March 2006 the FASB issued FASB Staff Position (FSB) *FTB 85-4-1 Accounting for Life Settlement Contracts by Third-Party Investors*. The life settlement market exists because some policyholders wish to realise cash from their life insurance contracts, and can obtain more than the surrender value by selling their contracts to outside investors.

17. For the purpose of the FSP, a life settlement contract is a contract between the owner of a life insurance policy (the policy owner) and a third-party investor (investor) and has the following characteristics:

(a) The investor does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy).

(b) The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy.

(c) The contract pays the face value of the life insurance policy to an investor when the insured dies.

18. The FSP introduces an election for investors in life settlement contracts. The investor may elect to account for its investments in life settlement contracts either using the

investment method or at fair value. The election is made on an instrument-by-instrument basis and is irrevocable.

19. Under the investment method, an investor:

    (a) recognises the initial investment at the transaction price plus all initial direct external costs.

    (b) capitalises continuing costs (policy premiums and direct external costs, if any) to keep the policy in force.

    (c) does not recognise any gain until the insured dies.

    (d) reduces the carrying amount of the investment to fair value if the carrying amount exceeds the expected undiscounted net cash inflows.

20. Before the issuance of this FSP, FASB Technical Bulletin 85-4, *Accounting for Purchases of Life Insurance* required the investor to recognise as an asset the amount that could be realised under the insurance contact. As a result, the investor was required to expense the excess of the purchase price over the cash surrender value.

IASB Staff recommendation

21. In January 2005, the Board reviewed a project plan. As proposed in that project plan, the staff recommends that the Board should not consider any aspect of policyholder accounting until after the Discussion Paper stage.

Emerging Issues Task Force – Insurance issues

22. There are currently two insurance related issues on the EITF's agenda.

23. The first issue is titled "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Split-Dollar Life Insurance Arrangements." Companies purchase life insurance for various reasons that may include protecting against the loss of "key" employees, funding deferred compensation and postretirement benefit obligations, and providing an investment return. Split-dollar life insurance is an arrangement in which the employer and an employee split the premiums and share the cash surrender value and/or death benefits of the insurance policy. For example, the employer and employee may share the cost of the premiums, or the employer may pay all of the premiums, and at the death of the insurer employee, the proceeds of the policy are split between the employer and the employee's estate.

24. The issue is how should the employer account for the deferred compensation or post-retirement benefit aspects of a split-dollar life insurance arrangement. View A would require that a liability be recorded by the employer. View B would require that no liability be recorded as the purchase of the insurance settles the obligation.

25. The second issue is titled "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*." Life insurance policies are purchased by entities for a variety of purposes, including recovering the cost of providing employee benefits and protecting against the loss of "key persons." These policies are generally known as corporate-owned life insurance (COLI) or bank-owned life insurance (BOLI). In determining the amount that could be realised under TB 85-4, certain life insurance contracts allow for the waiver of surrender charges if all life insurance contracts within a group are surrendered at the same time. These can be in the form of a group policy with individual certificates or individual policies with a group rider.

26. The issue is whether an entity should consider the contractual ability to surrender all of the individual life policies (or certificates under a group life policy) together when determining the amount that could be realised in accordance with TB 85-4. View A asserts that the amount realised should be determined on an individual life policy (or certificates under one group life policy) level. View B asserts that the amount realised should be determined based on surrendering all of the individual life policies (or certificates) at the same time.

27. Both of these EITF Issues are scheduled to be discussed at the June 14-15, 2006 EITF meeting.

IASB Staff recommendation

28. In January 2005, the IASB reviewed a project plan. As proposed in that project plan, the IASB staff recommends that the Board should not consider any aspect of policyholder accounting until after the Discussion Paper stage.

AGENDA PAPER 4F
SALVAGE AND SUBROGATION

Purpose of this paper

1. This paper discusses salvage and subrogation.

2. The staff does not view this as a critical issue and does not expect the discussion paper to address it in depth.

Summary of recommendations

3. This paper recommends the following:

   (a) Insurance liabilities should be measured net of the impact of related salvage and subrogation rights that the insurer would acquire on paying a claim. (paragraph 6)

   (b) Once an insurer acquires salvage or subrogation rights (generally by paying a claim under the insurance contract), the insurer has an asset. The insurer should measure that asset initially at current exit value. (paragraph 7)

   (c) Until the Board has discussed reimbursement rights in the project to amend IAS 37, the Board should not conclude on how an insurer should measure salvage and subrogation rights after initial measurement. (paragraph 9)

Background

4. An insurance contract often gives the insurer the right to sell (usually damaged) property acquired in settling the claim (salvage). The insurer may also have the right to 'stand in the shoes' of the policyholder and pursue legal remedies, if any, against third parties that caused the insured loss (subrogation).

5. IAS 37 deals with two related areas, expected disposals of assets and reimbursements.

   (a) Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on disposals of assets at the time specified by the standard dealing with the assets concerned.[5]

   (b) Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. Because the enterprise would have to settle the full amount if the third party failed to pay, the enterprise should recognise the reimbursement as a separate asset, not as a deduction from the provision. The amount recognised for the

[5] IAS 37, paragraphs 51 and 52. The June 2005 exposure draft of amendments to IAS 37 contains no equivalent paragraphs. A paper for the May and 2005 Board meetings suggests that these paragraphs were deleted because they were redundant and, therefore, confusing.

reimbursement should not exceed the amount of the provision. In the income statement, the expense relating to a provision may be presented net of the amount recognised for a reimbursement. [6]

6. IAS 37 contemplates cases where an enterprise pays the creditor and then obtains a recovery by selling an asset or by claiming reimbursement from another party. However, salvage and subrogation differ because the insurer pays the claim and, in doing so, receives salvage rights or subrogation rights from the policyholder (rather than from another party). In determining an acceptable transaction price for a hypothetical transfer of the obligation, market participants would consider both the cash payment and the salvage or subrogation rights. Therefore, the staff proposes that insurance liabilities should be measured net of the impact of related salvage and subrogation rights that the insurer would acquire on paying a claim.

7. Once an insurer acquires salvage or subrogation rights (generally by paying a claim under the insurance contract), the insurer has an asset. To avoid discontinuities in measurement at that point, the staff recommends that the insurer should measure that asset initially at current exit value.

8. Subsequently, there are two obvious possibilities for measuring the salvage or subrogation rights:

   (a) Continue to measure those rights at current exit value. This would be consistent with the measurement at initial recognition.

   (b) Measure those rights consistently with similar assets:

      (i) For subrogation rights, the asset is an acquired intangible asset (a right to pursue legal remedies).[7] Under IAS 38, this asset would be measured at cost, less amortisation and less any impairment losses. Presumably, the initial measurement of the asset would become its deemed cost. Because the mere passage of time would not typically cause any consumption of the expected future economic benefits embodied in the asset, amortisation would typically be zero.

[6] IAS 37, paragraphs 53-56. The equivalent paragraphs in the June 2005 exposure draft are 46-49 (see appendix to this paper).

[7] For an explanation that an item of this kind is an intangible asset, not a contingent asset, see paragraphs 17A and 17B of IAS 38 as proposed by the June 2005 exposure draft of amendments to IAS 37, reproduced in the appendix to this paper.

(ii) For salvage rights, there are two stages to consider

1. until the insurer takes control of the damaged property, the right to take control of it would be an acquired intangible asset and under IAS 38 would presumably be treated in the same way as discussed above for subrogation rights.

2. after the insurer takes control of the damaged property, the property is held for sale. If regarded as held for sale in the ordinary course of business, it meets the definition of inventory in IAS 2 and would be measured at the lower of cost and net realisable value.

9. The staff recommends that the Board should not consider how an insurer should measure salvage and subrogation rights after initial measurement until the Board has discussed reimbursement rights in the project to amend IAS 37.

Appendix
Extracts from Exposure Draft of Proposed Amendments to IAS 37 and IAS 19 (June 2005)

REIMBURSEMENTS

46 When an entity has a right to be reimbursed by a third party for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably. The amount recognised for the reimbursement right shall not exceed the amount of the non-financial liability.

47 Sometimes, an entity has a right to look to another party to provide part or all of the economic benefits that will be required to settle a non-financial liability (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or settle the amounts directly. Although the reimbursement itself is a conditional right, the unconditional right to receive reimbursement satisfies the definition of an asset and is recognised if it can be measured reliably.

48 An entity shall not offset against the non-financial liability the amount recognised for the reimbursement right.

49 Because the reimbursement is receivable from a third party, there would not be a legally enforceable right of set-off and, therefore, the non-financial liability and the reimbursement right are recognised separately. However, if the entity will not be liable for the amounts required to settle the obligation if the third party fails to pay, the entity has no liability for these amounts and they are not reflected in the measurement of the liability.

50 In the income statement, the expense relating to a non-financial liability may be presented net of the income resulting from the reimbursement right.

A22 IAS 38 *Intangible Assets* is amended as described below.

After paragraph 17 a new heading and paragraphs 17A and 17B are added, as follows.

Contingencies

17A In some cases, an entity has an intangible asset even though the amount of the future economic benefits embodied in that asset is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In such cases, an entity has two rights as a result of a past event, an unconditional right and a conditional right. The intangible asset arises from the unconditional right, but the conditional right is reflected in the measurement of the intangible asset.

17B An example of such an intangible asset is a product warranty. The entity's asset arises from its unconditional right to warranty coverage for the duration of the warranty contract rather than from its conditional right to have its product repaired or replaced if it develops a fault. Similarly, an entity that is pursuing a legal claim has an intangible asset arising from the actions it performed to get to the point of pursuing its claim. Any amounts that the entity expects to receive as a result of pursuing a legal claim are a conditional right, because the right to receive them is conditional on a future event (eg the judgement of the court).