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International Financial Reporting Standards

IASB/FASB: Differences in tentative decisions

Insurance Contracts

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Main differences

- Acquisition costs
- Margin
  - Risk adjustment
  - Accretion of interest
- Participating contracts

Acquisition costs

- IASB/FASB: expense when incurred
- IASB: at inception, residual margin excludes an amount equal to incremental acquisition costs
- FASB: no exclusion from initial margin

ARGUMENTS	
EXCLUDE FROM INITIAL MARGIN •Initial measure closer to economic value •Calibrates initial margin to observable number (**premium less incremental AC**) •For cedant, no need to distinguish premium from ceding commission	NO EXCLUSION •Consistent with revenue recognition project (no performance at inception) •Calibrates initial margin to observable number (**premium**)

Margin

Risk adjustment?

- IASB: yes, plus residual margin
- FASB: no, single composite margin

ARGUMENTS	
INCLUDE RISK ADJUSTMENT •Insurance is all about taking and managing risk •Explicitly measures risk •Insurers and their investors care about risk •Less pressure on run-off pattern for residual/composite margin	COMPOSITE MARGIN •Is it relevant? (insurance model is fulfilment, not a market transfer) •Subjectivity and complexity (diverse methods, what is objective?) •Consistency with revenue recognition project

Margin

Accrete interest on residual/composite margin

- IASB: yes
- FASB: no

ARGUMENTS	
ACCRETION •Consistent with overall model •Discounted balance at inception (difference between two discounted balances) •Consistent with revenue recognition project	NO ACCRETION •Residual or composite margin is just a deferred credit with no meaning •More complex

Participating contracts

- IASB: include participating payments in the same way as any other contractual cash flow (expected present value)
- FASB: include participating payments to the extent that the insurer has an obligation to pay

ARGUMENTS	
CASH FLOW AS ANY OTHER •Consistent with overall approach •Hard to assess whether an obligation exists •Inverse relationship between claims and participating payments •Cash flows depend on each other (eg lapse and participation)	OBLIGATION •Consistent with Framework •Consistent with financial instruments •Shows loss absorbing feature

Other differences

- Definition
- Embedded derivatives
- Derecognition
- Portfolio transfers

[The staff anticipates that these other differences can be dealt with through drafting (some suggestions included in the next slides, or, if necessary, as sweep issues.]

Definition

When does insurance risk exist?

- IASB: consider the range of outcomes
- FASB: consider whether there is at least one scenario in which PV of net cash outflows can exceed PV of premiums

ARGUMENTS	
RANGE OF OUTCOMES •If outcomes can vary, some are worse than expected value •Less sensitive to discount rate •No reason to tinker with existing definition in IFRSs	NET CASH OUTFLOWS - PREMIUM •Intuitive to think in terms of loss over the whole life of the contract. •Similar notion in US GAAP

Embedded derivatives

- IASB: unbundle according to IAS 39
  - closely related if embedded derivative and host insurance contract are so interdependent, they can't be measured separately (IAS 39 AG33(h))
- FASB: unbundle using principle being developed for insurance contracts
  - unbundle unless components so interdependent, they can't be measured separately
- Staff conclusion:
  - Both approaches lead to the same outcome.

Derecognition

- IASB: derecognition principle in IAS 39
  - Derecognise the liability when it is extinguished, ie when obligation is discharged or cancelled or expires
- FASB: the entity is no longer at risk [and no longer required to transfer any economic resources for that obligation]
- Staff conclusion: keep IAS 39 principle, add statement that when a contract is extinguished, the insurer is no longer at risk and no longer required to transfer any economic resources for that obligation

Portfolio transfers

- If expected present value of the cash flows (plus risk adjustment) exceeds the consideration received:
  - IASB: recognise a loss
  - FASB: EPV of cash flows (plus risk adjustment) cannot exceed the transaction price (if parties unrelated)

ARGUMENTS	
RECOGNISE A LOSS Loss unlikely, but arguably exclusion of own credit might lead to loss	LOSS IMPOSSIBLE Loss cannot arise (unless parties are related or transferee is irrational)