Staff Paper

Project **Insurance contracts**

Topic **Project assumptions**

What is this paper about?

1. The purpose of this paper is to describe the axioms and assumptions that will underlie the development of papers that the staff will bring to the Board to finalise the proposals in the IASB's exposure draft *Insurance Contracts* ('the ED') and the FASB's discussion paper *Preliminary Views on Insurance Contracts* ('the DP').

2. We have not reproduced in this paper any arguments in favour or against these assumptions. Those arguments were included in the Basis for Conclusions to the ED/DP and the IASB's 2007 DP.

Axioms and assumptions

3. We will treat as axioms:

   (a) that an ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.

   (b) that the accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.

(c) that money has a time value and that an entity more faithfully represents its position when it measures its liabilities in a way that includes the time value of money.

4. We will also make the following assumptions:

(a) The boards will develop a standard for insurance, rather than requiring current or proposed generic standards that might otherwise apply to such contracts.

The comment letters on the ED were generally supportive of the need to develop an IFRS that deals with insurance, and we will assume that the IASB will develop the proposals in the ED into an IFRS that will replace IFRS 4. There is currently guidance in US GAAP that is specific to insurance and we will assume that the FASB will develop proposals specific to insurance to replace that guidance.

(b) The standard will deal with the accounting for insurance contracts from the perspective of the insurer, and not for the assets backing the contracts or for the entities that issue those contracts.

This is consistent with the boards' general view that users of financial statements need to be able to compare similar activities, transactions and events of different entities on a consistent basis.

(c) The boards will develop a standard based on an accounting model that regards insurance contracts as creating a bundle of rights and obligations that work together to generate a package of cash inflows and outflows.

This approach was widely supported in the comment letters on the ED/DP and we will assume that the boards will not revisit this approach.

(d) In general, the final standard will measure insurance contracts at the portfolio level.

Almost all respondents supported measuring insurance contracts at the portfolio level (although some requested further guidance on the definition *of a portfolio). We will assume that the unit of account is generally the portfolio, unless different considerations apply to specific instances.*

(e) The accounting model should be based on:

(i) current estimates, rather than carrying forward estimates made at contract inception.

An approach that uses current inputs was largely supported in the responses to both the IASB's 2007 DP and the ED/DP. However, we will consider in a future paper whether the discount rate should be locked-in at inception for some types of insurance contract or where the assets backing the insurance contract are measured at cost.

(ii) inputs that are consistent with observable market data.

The responses to the ED/DP, like the responses to the IASB's 2007 DP, supported an approach that uses inputs consistent with observable market data. However, as noted in (d)(i), we will consider in a future paper whether some inputs might be locked-in at inception in some circumstances.

(f) The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract.

Almost all respondents to the ED/DP believe that the proposal that insurers should measure their insurance contracts using cash flows that will arise through fulfilment is a significant improvement over the exit value approach proposed in the IASB's DP of 2007.

(g) The model will use the expected value of future cash flows rather than a single, most likely outcome.

Most support the use of expected value in principle, though, as with the IASB's 2007 DP, some respondents expressed concerns about the references to probability-weighted cash flows in the ED because they believed the boards intended to preclude other methods of determining expected value.

Although these concerns were sometimes expressed in terms of disagreement with using probability-weighted cash flows, the root of many of the concerns seemed to be about how this principle would be applied in practice.

We will consider how we can address some of the concerns about application in a future paper. However, as the measurement objective was widely supported both in the responses to the IASB's 2007 DP and the ED/DP we will assume that the measurement objective is expected value.

(h) The measurement of the liability will not reflect changes in the insurer's own credit standing.

Most respondents opposed the inclusion of changes in the insurer's own credit standing in the measurement of the insurance liability.

We will assume that the boards will confirm that the measurement of the liability should not reflect changes in the insurer's own credit standing. However, at this stage we will not rule out further consideration of whether the measurement of the liability should incorporate the insurer's own credit standing at inception, or reflect changes in general market credit spreads.

5. Although we will revise these assumptions if necessary, we believe that it will be helpful to have a common understanding of the factors that influence the staff in their analysis.

Project assumptions
Do you agree that the staff should use the axioms and assumptions described in this paper? If not, which do you disagree with, and why?