



## Consequences of the Financial Crisis on the IASB Insurance Project

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### Introduction

Accounting, accounting standards and accounting standard setters, namely the IASB have been in the spotlight during the financial crisis. The IASB has not included its project on Insurance Contracts in the list of its responses to the financial crises<sup>1</sup>—and it was not asked to do so e.g. by the G-20<sup>2</sup>. However, it is perhaps not unfair to state that some decisions made on this project<sup>3</sup> over the last months have been influenced by the conclusions and experience in the context of the financial crisis, especially the criticism of models and their reliability.

One of the most controversial issues so far has been the treatment of initial gains, which result from a comparison of premiums an insurer receives and recognises as income with the value of the recognised liability under the same contract. The IASB now holds the view—and this is a change from the proposals in the Discussion Paper published in 2007<sup>4</sup>—that the liability at inception should be measured by reference to the premium and therefore at no moment should gain be recognised in the profit-or-loss-account, i.e. a Customer Consideration Approach as basis of measurement. Even if not explicitly stated, we assume that the IASB made that decision in order to respond to concerns about the reliability of accounts that are purely based on modelled fair values. It is actually reasoned by reference to the Revenue Recognition Project, where initial gains are rejected due to the complexity and risk of error inherent in models used to estimate current exit values.<sup>5</sup> Even if insurance has not been the primary focus of that project, it addresses similar issues found in insurance contracts if understood as a performance obligation, specifically the provision of services, rather than simply a kind of financial instrument.

Furthermore, the IASB moved to substitute the Current Exit Value with a more realistic value reflecting that the reporting entity typically satisfies the performance obligation (here referred to as Current Fulfillment Value, although that term was never unanimously defined), mainly in relation to the current revision of IAS 37.<sup>6</sup> The Current Exit Value is what standard setters expect to be the Fair Value<sup>7</sup> and describes a value arising from the assumption the obligation by a fictitious acquirer. The move left any measurement of required consideration in form of required profits, portfolio specific cash flows (e.g. claims ratio), and effects resulting from the financial environment (e.g. discount rates) unchanged.

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<sup>1</sup> <http://www.iasb.org/About+Us/About+the+IASB/Response+to+the+credit+crisis.htm>.

<sup>2</sup> G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, Final Report, 25 March 2009, Recommendations 13, 22 and 23.

<sup>3</sup> For information on the current status see:

<http://www.iasb.org/Current+Projects/IASB+Projects/Insurance+Contracts/Insurance+Contracts.htm>.

<sup>4</sup> See IASB Discussion Paper *Preliminary Views on Insurance Contracts*, and Duverne/Le Douit in *The Geneva Papers* 2008, 33 (1): 41-53.

<sup>5</sup> See Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, 5,21 and 5.24.

<sup>6</sup> For information on the current status see: <http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities/Liabilities.htm>.

<sup>7</sup> IASB Exposure Draft ED/2009/5 Fair Value Measurement, paragraph 1.

Exclusively, necessarily entity-specific cash flows, such as the cost of contract administration, customer servicing and the specific claims settlement approach, are modified in relation to the Current Exit Value. Already the Revenue Recognition Project refers to a Current Exit Value regarding service contracts as being counterintuitive<sup>8</sup> and the revision of IAS 37 proposes to use the entity-specific value in absence of efficient markets.<sup>9</sup>

In the following paper we particularly consider the question of subsequent measurement as a continuation of our earlier thoughts on a reliable fair value.<sup>10</sup> This is particularly relevant in the context of the very long-term obligations of insurance, where a calculation is made at the start and then reduces in relevance. We propose a subsequent measurement approach that combines both the current information of a prospective Fulfilment Value with the reliability and profit recognition patterns of a Customer Consideration approach.

### **Combination of Current Fulfilment Value and Customer Consideration Approach**

While the Current Fulfilment Value is a prospective fresh start approach, the Customer Consideration Approach is described as reverting to historic information and is not entirely a fresh start approach. Like the Fair Value, the Current Fulfilment Value might include some retrospective and starting elements that are not new, but those elements are applied to eliminate subjectivity when non-observable information is needed.<sup>11</sup> That is merely measurement guidance to achieve robustness, but not a conceptual requirement. It assumes that the past situation is the best available information about the current position in absence of up-to-date actual market information. Therefore, Fair Value and Current Fulfilment Value remain conceptually prospective fresh start approaches, even if they consider past data to a limited extent.

The Customer Consideration Approach, on the other hand, introduces that reflection of past data into the concept itself. In the absence of suitable current market information, the Fair Value, the Current Fulfilment Value and the Customer Consideration Approach might result in the same outcome. One may believe that it is more reliable to directly use the Customer Consideration Approach for contracts with the least significant servicing elements, since in those cases a transfer is very unusual or even impossible and consequently relevant market information is not available in general or at least is practically irrelevant. The Customer Consideration Approach would consequently be the more reliable measurement methodology in those cases, which are, in practice, the vast majority of insurance contracts.

Consequently, the IASB is currently discussing the application of the Customer Consideration Approach in profitable insurance contracts, as proposed in other performance obligations in the Revenue Recognition Project. In case of onerous contracts, the Current Fulfilment Value based on the three building blocks is to be reported as the minimum amount. Actually, the three building blocks are also the underlying concept of the Revenue Recognition Project, where the margin is determined as the residuum between the current estimate of cash flows and the customer consideration, if any. That element provides the reliability of an objective measurement. The requirement to apply the three building blocks stringently also in the case of onerous contracts ensures the required realism. Such an approach makes use of any available knowledge about any potential loss without reporting gains based on models. Further, it enhances transparency and avoids complexity as long as possible.

Projects could be more realistic if instead of a simplified version of the three building blocks of the Revenue Recognition Project, a sophisticated approach as discussed currently in the revision of IAS 37 is applied for onerous contracts. The preliminary view requires, at least in case of risky obligations such as insurance contracts, a suitable margin which ensures that an adequate reflection of required risk-adequate profit is recognised throughout the contract term, even in the case of onerous contracts.

A further sophistication of the measurement objective in the revision of IAS 37 could consist in enhancing realism without reducing objectivity, rather than focusing on specific ways to relieve oneself of

<sup>8</sup> See IASB Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, 5.22.

<sup>9</sup> IASB Meeting Summary April 2009,

[www.iasb.org/Current+Projects/IASB+Projects/Liabilities/Meeting+Summaries+and+Observer+Notes/IASB+April+2009.htm](http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities/Meeting+Summaries+and+Observer+Notes/IASB+April+2009.htm)

<sup>10</sup> Engeländer/Kölschbach in *The Geneva Papers* 2006, 31 (512-527).

<sup>11</sup> See IAS 39.AG76 and AG76A.

an obligation through realistically available means. Three alternatives exist in this regard: transferring to an active market, settling directly with the customer or meeting the performance obligation. Such an approach would also help alleviate concerns regarding the disappearance of active markets.

### **Customer Consideration in subsequent measurement**

Principally, the subsequent measurement in current fresh start approaches is identical to the initial measurement. However, introducing retrospective elements for improvement of objectivity and verifiability causes similar issues in the case of the Customer Consideration Approach: how to continue an initial calibration, especially a calibration to the initial consideration received or paid? Any calibration at inception is done on purpose, since there is no objectively determinable distinct alternative value. The same is true for subsequent measurement. Especially in case of very long-term obligations, a calibration at initial measurement relevancies in wane, if subsequently measurement of lacking objectivity can be applied. To be useful, any calibration technique needs to be continued at a subsequent measurement date, until the conditions that would not require a calibration in the case of initial measurement are met. In case of long duration performance obligations provided by an important industry like insurance, the recommendations to enhance objectivity, transparency and verifiability and reducing complexity should be achieved specifically in subsequent measurements, applicable often for decades, rather than only in the very first year during initial measurement.

In absence of paid consideration, the equivalent alternative for a calibration basis could be a “projected book value”. The projected book value is the amount assumed at the end of the prior period, to be reported at the end of the current period, including the projected percentage-of-completion revenue (with the inherent profit), based on assumptions of the prior period. Any choice of assumptions in the measurement at the end of the current period should be disciplined by that projected book value as the choice of initial assumptions is disciplined by the consideration received resulting in a respectively determined margin. The original consideration received is the root of the projected book value determined during the calibration process. If that is also applied to the margins under a prospective fresh start approach to improve objectivity and verifiability, the prospective character is only limited by the need to compare the current estimate of liability with the prior projected book value—any other historic value does not matter. As in the case of initial measurement, the prospectively determined Current Fulfilment Value is always the minimum amount of liability, i.e. using margins as required under the proposals for revision of IAS 37. It is important that the calibration approach be applied to the entire net contract asset or net contract liability as required, as in the case of the Revenue Recognition Project.

To comply with the concept, changes of individual parameters of the applied valuation technique should not affect the entire value. That applies even if certain parameters can be determined more objectively than others. To achieve objectivity, a significant degree of indeterminacy of the entire asset or liability should not allow recognising gains or losses from changing isolated observable assumptions within the measurement technique applied if those changes are within the range of the overall indeterminacy of the asset or liability. That is relevant in a situation where one assumption is changed, but all other, non-observable assumptions could be chosen reasonably in a manner that the outcome equals the projected book value. The entire value after the change of one single assumption is actually not more reliable than the projected book value and consequently the projected book value should be reported since there is no better value available. The measurement technique and the split of measurement in a set of assumptions and parts of the value should especially not influence the outcome.

However, that approach may cause issues if the contracts include components that can be matched with actively traded items whose effect on cash flows is identifiable separately. It might be suitable to provide an accounting option at outset of the contract to exclude those components which are actually separable and traded in active markets from the calibration approach, i.e. to apply the calibration only to the measurement of components that cannot be matched. That would hardly apply to performance obligations, but might apply to embedded financial instruments. If they could be completely matched in reality, since they are separable and traded in active markets, their initial market price should be considered separately at outset and any effect of changing market prices should be considered in subsequent measurement fully affecting the profit-or-loss-account. That is necessary to avoid an accounting mismatch if the entity actually matches the component.

## **Conclusion**

The IASB is currently making significant progress on its project on insurance contracts accounting. By referring to other projects such as Revenue Recognition and the review of IAS 37 on (uncertain) liabilities in general, it is not only striving for cross-industry comparability, but also for objectivity and reliability, in an underlying approach applied not only to the initial, but also the subsequent measurement of insurance liabilities. However, the focus of the IASB in response to the crisis is currently on issues relating to financial instruments, consolidation and de-recognition. At this point in time, it is not possible to make an overall and in depth evaluation of the impact those factors will have on insurance.

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