

CFO Forum

Elaborated Principles for an IFRS Phase II Insurance Accounting Model

Elaborated Principles and Basis for Conclusions

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CFO Forum Elaborated Principles for an IFRS Phase II Insurance Accounting Model

Introduction

Following the publication of its 'Principles for an IFRS Phase II Insurance Model' in July 2005 the CFO Forum has continued to develop the high level principles, leading to the publication in June 2006 of the CFO Forum's 'Elaborated Principles for an IFRS Phase II Insurance Model' and supporting documentation. The purpose of these documents is to provide timely and constructive input into the IASB's process for developing a 'Phase II' *insurance contracts* standard, from the perspective of a significant group of companies who are both investors in the financial markets and preparers of financial statements that incorporate *insurance contracts*.

The CFO Forum has considered how these general principles will apply to participating contracts, which are specifically addressed in an addendum to this document: Clarification of the Elaborated Principles in respect of Participating Contracts. The CFO Forum has yet to determine how these Principles apply with respect to reinsurance assets.

The purpose of this document is to present and to provide insight into the CFO Forum's Elaborated Principles for an IFRS Phase II Insurance Accounting Model. The document also provides background explanation about how the CFO Forum considers various aspects of the insurance accounting model should operate, and further observations on how an accounting standard making use of these principles might be developed for use in practice.

Definitions are consistent with 'Defined Terms', which can be found at the end of this document. All Defined Terms have been shown in italics.

Note on the layout of the Elaborated Principles and Basis for Conclusion

The Elaborated Principles and Basis for Conclusion are set out in the following format within this document:

A. Main Principle

EP1) Elaborated Principle (or EPP1 for Elaborated Participating Contracts Principles in the addendum).

BC1) Basis for Conclusion.

1) Accounting Model for *Insurance Contract* Measurement

A. Accounting profit should be recognised in line with the release from risk.

EP1) The main service provided by an insurer is the acceptance and management of risk associated with *insurance contracts*. It is a characteristic which, by definition, sets *insurance contracts* apart from other contracts.

BC1) The insurance business model is based on pooling and management of risk over time.

BC2) *Insurance contracts* generate both cash inflows and cash outflows. By the nature of the risks accepted and the uncertainty surrounding their timing, the cash flows themselves are subject to uncertainty.

BC3) The insurer is providing insurance cover continuously over the term of each contract and profit should be recognised accordingly. Under normal circumstances, the risks accepted by an insurer reduce over the term of the contract. Since the main service under *insurance contracts* is the mitigation of risk, entities selling *insurance contracts* should recognise accounting profits from those contracts in line with the reduction of risk.

BC4) The profit generated by the contract depends solely on cash inflows and cash outflows. The recognition of these profits in each reporting period during the term of the contract depends on both the actual cash flows in the period and the change in estimation of *insurance liabilities* over the period.

BC5) All expected future cash flows arising from the contract are taken into consideration in determining a *best estimate* of future profit. For accounting purposes, this profit will be recognised in line with release from risk. That is, when the service is provided, and hence it is inappropriate to recognise anticipated profit at outset.

Risk profile

EP2) The insurer should assess the anticipated pattern of risk and uncertainty inherent in the *insurance contracts* (the *risk profile*). This *risk profile* determines the pattern of profit recognition.

EP3) The *risk profile* differs between:

- The pre-claims liability, which relates to the coverage period when the insurer provides the service of accepting and managing the risks to its policyholders. During the coverage period, the insurer is at risk of insured events occurring with varying severity; and
- The post-claims liability, which relates to the settlement period in between claims being incurred and claims being settled. During the settlement period, the insurer is at risk of the incurred claims varying in amount and timing of payment.

The coverage period and the settlement period overlap. In practice, the settlement period is not material for life insurance business.

- EP4) The total margin should be recognised over the coverage period, in line with the *risk profile* for the pre-claims liability. The post-claims liability should include only an allowance for inherent risk and uncertainty and that will be released in line with its *risk profile*.
- EP5) The total margins for a portfolio of contracts are, in general, assessed at inception as the present value of all cash inflows expected to be received from the portfolio, less the present value of all expected future cash outflows arising from the portfolio. Such margins will emerge as profit if actual experience occurs in line with expectations. As described above, these total margins are released over the coverage period.
- EP6) In certain circumstances, the 'release from risk' approach may be closely approximated by the current 'unearned premium reserve' approach and hence the current unearned premium reserve approach could be a surrogate where the risks are assumed to be of equal intensity across the coverage period.
- BC6) Entities underwriting *insurance contracts* will be exposed to a number of risks including, for example, insurance risk, persistency risk and market risk. In a number of instances these risks are interdependent.
- BC7) Various techniques are possible for determining the level of risk attaching to an *insurance contract* at a particular point in time. The CFO Forum has focused on the nature of risks attaching to *insurance contracts* and considers that individual facts and circumstances will determine the *risk profile* for accounting purposes.
- BC8) Subject to a liability adequacy test, the appropriate measure of the total margins at outset are those incorporated into the premium basis, and this is reflected in the EP4.

Changes in the *risk profile*

- EP7) If the *risk profile* has changed, then the future profit recognition profile is amended in accordance with the new *risk profile*. For the avoidance of doubt, the change in future *risk profile* does not require changes to profits previously recognised.
- BC9) For some *insurance contracts*, expected profits will be recognised over many years. Over that time, management's view of the expected future margins under the contract will change, for example, due to the actual incidence of claims and loss severity. Actual experience will directly impact on the profits reported under a contract and may also change management's *best estimate* of assumptions used to estimate the expected future profits. In addition to affecting the expected future profit, changes in assumptions may also indicate changes in the *risk profile*. Changes at each reporting date would be applied prospectively and there is no requirement for previously reported figures to be restated.

B. The liability should be based on the present value of all future cash flows with allowance for the inherent risk and uncertainty. The cash flows should reflect management's *best estimate* of the future.

- BC10) A prospective assessment of future cash flows is the most relevant view of the entity's obligations under a portfolio of contracts. The CFO Forum believes it is appropriate for the liability to be the discounted value of the obligations to reflect the *time value* of money. As noted under Principle A, the cash flows from a portfolio of contracts are inherently uncertain and as a consequence there is a need to include a margin for risk and uncertainty.
- BC11) *Insurance liabilities* are determined in part by economic factors such as interest rates which can be assessed objectively from market data. However, a major part of the experience reflects non-financial factors such as claims frequency and claims amount. These non-financial factors depend heavily on the entity's target population and underwriting. For these factors there is no market to provide a consensus view of future experience and in consequence the CFO Forum believes that the most relevant estimate is that developed by management.

Best estimate

EP8) The *best estimate* should be equal to the mean estimate (probability weighted average) so that the liability valuation should consider both the amount and likelihood of future cash flows.

- BC12) The term *best estimate* means different things to different people and is defined in various ways across the breadth of legislation, regulation and financial reporting. Some of the current uses include:
- The 'mean' estimate or 'probability weighted average' estimate;
 - The 'median' estimate also known as the '50:50' estimate or the 'central' estimate: this refers to an estimate where there is an equal likelihood that the estimate will prove to be too small or too large;
 - Prudent estimates where either there is an explicit margin to increase the estimate or individual assumptions are adjusted to incorporate an implicit margin for prudence;
 - IAS 37 definition of *best estimate* being the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time.

The CFO Forum believes that the *best estimate* should be equal to the mean estimate (probability weighted average) so that the liability valuation should consider both the amount and likelihood of future cash flows.

- BC13) Management's *best estimate* of the future should not include any margins for risk and uncertainty since an additional allowance for risk and uncertainty is included elsewhere in the liability valuation. Where a market rate is used, this would implicitly include margins for risk and uncertainty and no further margin is needed.
- BC14) The assessment of *best estimate* refers to the valuation of future cash flows in aggregate, not to each individual assumption. In practice, it can be very difficult to determine whether an individual assumption is a *best estimate*. In many cases, it is not the individual assumption that is important but its relationship with other assumptions. Management should be satisfied that the

aggregate valuation basis reflects their view of the probability weighted average of expected future cash flows prior to an allowance for risk and uncertainty.

Allowance for risk and uncertainty

EP9) The allowance for inherent risk and uncertainty should be determined by management in a manner that reflects the characteristics of the expected future cash flows. The allowance for inherent risk and uncertainty is in addition to those cash flows that represent management's *best estimate*.

BC15) The allowance for inherent risk and uncertainty should reflect management's perception of the risk and uncertainty attaching to the future cash flows from a portfolio of *insurance contracts*. The assessment should take into account all information available at the *valuation date* including the variability of incidence and severity of future cash flows and uncertainty relating to external and internal factors.

BC16) When quantifying the allowance for inherent risk and uncertainty, various techniques are available, including cost of capital and confidence interval approaches. The CFO Forum has focused on the nature of the allowance for inherent risk and uncertainty attaching to *insurance contracts* and considered that individual facts and circumstances will determine the allowance for inherent risk and uncertainty for accounting purposes.

Discount rate

EP10) A discount rate is required to adjust the *insurance liability* for relevant financial factors, notably the *time value* of money. The appropriate discount rate is the risk free rate of return specific to the liabilities being measured.

EP11) Certain liabilities may not be subject to particular aspects of financial risk, such as liquidity risk. In such cases, the market risk free rate should be adjusted to reflect the absence of these risks. As a proxy for determining this adjustment, it may be appropriate to consider the yield on debt instruments with similar characteristics, such as corporate bonds. The yield should be adjusted to remove any premium for risks that are not relevant to the liability being evaluated, for example default risk.

EP12) Where the value of the *insurance liability* is linked, contractually or through other legal or regulatory terms, to the value of associated assets, the value of the *insurance liabilities* is calculated with reference to the market value of the assets at the *valuation date*.

BC17) Certain categories of *insurance liabilities* do not carry liquidity risks and should be discounted at a risk free rate of interest that is not reduced for liquidity risk. In practice, estimation techniques could permit adjusting corporate bond rates for the risk of default or adjusting risk free market rates to allow for the liquidity risk premium in corporate bonds.

BC18) The approach described in EP10, while apparently retrospective, is consistent with the prospective approach envisaged in Principle B. This is because the future cash flows from unit-linked and similar products are usually dependent on the value of the underlying assets.

BC19) A discount rate specific to the liabilities being measured should take into account the term of those liabilities as well as the risk characteristics. Discount rates suitable for future cash flows would be determined using a yield curve. For very long maturing liabilities it may be necessary to extrapolate the yield curve to longer durations. In practice, a single discount rate may be a suitable proxy for the yield curve, albeit entities would need to be satisfied that this approximation did not lead to a material misstatement of the *insurance liabilities* in the financial statements.

Aggregate valuation

EP13) The CFO Forum Principles require the insurer to recognise all obligations and rights arising from *insurance contracts*. Consequently, the unbundling of any individual component of an *insurance contract* is not required.

BC20) The component features of *insurance contracts* are linked and interdependent. Separation of *insurance contracts* into their component features, whilst possible for some simple contracts, would require assumptions about how the component features operate in isolation. These additional assumptions increase the subjectivity of the liability valuation. The appropriate basis is to evaluate *insurance contracts* in aggregate, taking into account all the components of the contracts.

BC21) IFRS 4 currently states that unbundling is not required if the accounting model recognises all obligations and rights arising from *insurance contracts*. These Principles have been developed so that they do require all obligations and rights to be recognised and consistently measured. Therefore unbundling is unnecessary.

As a consequence of Principles A and B:

- i) **On initial measurement, there should be nil gains or accounting losses. Economic losses should be reflected both on initial and subsequent measurement.**

Nil gains

- EP14) At inception, all expected future cash flows arising from the contract, after allowance for risk and uncertainty, should be taken into consideration in determining a *best estimate* of future profit or loss. Any profit should be recognised in line with release from risk, and hence nil gains are reported on initial measurement.**

BC22) Within Principle A, the CFO Forum has concluded that the primary criterion for recognition of profit is release from risk under the contract. Release from risk occurs over time, as the period of cover elapses, and hence, the CFO Forum cannot envisage circumstances where a contract would give rise to a release from risk on inception of a contract. Therefore, a nil gain should be reported at inception.

Nil accounting losses

- EP15) The accounting basis should not result in reported losses in excess of an economic loss.**

BC23) The application of these Principles in their entirety would avoid such an accounting loss.

Economic losses

- EP16) An economic loss arises when the present value of all expected cash flows to the insurer under the contract, including an allowance for risk and uncertainty, shows that cash outflows exceed cash inflows.**

- EP17) Where an insurer has issued a contract that, at inception, is expected to ultimately yield an economic loss over the term of the contract, that loss should be recognized at inception.**

BC24) In some circumstances, the present value of expected net cash flows under an *insurance contract* at inception, including an allowance for risk and uncertainty, shows a net cash outflow. This net cash outflow represents an economic loss. This loss would be identified by a liability adequacy test that is independent of the pricing basis.

Liability adequacy test

- EP18) Recognition of profit in line with the *risk profile* is subject to a liability adequacy test such that, at inception or at any subsequent *valuation date*, the minimum value of the liability should not be less than that determined by the liability adequacy test. Any increase in the liability resulting from this test should be recognised immediately in the income statement. Such an increase should be reversed immediately if it no longer exists.**

BC25) Since the amount, timing and likelihood of the expected future benefit or claim payments are uncertain, the liability adequacy test and hence the measurement of economic losses should include an allowance for risk and uncertainty. This approach is consistent with market behaviour for pricing transactions.

BC26) The liability in the liability adequacy test should be that required by another insurer to take over the obligations arising from the portfolio.

ii) An insurance customer intangible asset should be set up to reflect the initial investment made in the customer relationship provided that it can be recovered from future profits.

BC27) Acquiring an *insurance contract* often incurs initial costs that exceed the cash inflows at inception. However, insurers are willing to incur such costs as they have acquired a customer relationship that is typically expected to generate total cash inflows in excess of total cash outflows including initial costs.

BC28) The CFO Forum has considered a number of possible approaches to account for these costs and related benefits. One approach is to recognise a separate intangible asset, reflecting the access to this future economic benefit.

BC29) The CFO Forum believes that it provides more relevant and useful information to present a separate customer intangible asset, instead of the alternative approach which reflects the recovery of acquisition costs in calculating the *insurance liability*.

Measurement of customer intangible

EP19) The customer intangible asset represents the access to future benefits obtained from a portfolio of contracts as a result of establishing the customer relationship. The best proxy for the value of the customer intangible asset at inception is the *initial acquisition cost* arising from the contract.

EP20) *Initial acquisition costs* represent all costs associated with procuring the *insurance contract*, including direct and indirect marketing and sales costs, and related overheads.

EP21) The customer intangible asset is realised over the term of the contract, reflecting the benefit of the customer relationship flowing from that contract.

BC30) The contractual customer relationship represents a right to access the future economic benefit arising from a contract and should therefore be recognised as an intangible asset. The contract the insurer has with a policyholder fulfils the definition of an asset, because it transfers contractual rights, namely future cash flows, which could be sold to a third party, for example, in a business combination.

BC31) The CFO Forum believes that *initial acquisition costs* should include both direct and indirect acquisition costs since this is more relevant to the management of the business and, for example, does not discriminate arbitrarily between offices that sell via independent agents and those that sell through in-house sales forces.

BC32) The CFO Forum considers this approach to be appropriate, since the risk of overstating the value of the intangible asset is mitigated by the requirement to test the asset for recoverability against future expected profit on the contract at each reporting date.

BC33) Consistent with Principle A, the customer intangible should be recognised in line with the profit recognition profile of the contract.

iii) Assumptions underlying the measurement of *insurance liabilities* and intangible assets should be periodically reviewed and updated if appropriate.

Reviewing and updating assumptions

EP22) Assumptions should be reviewed at each reporting date in order to incorporate relevant market information and management's *best estimate* of the future.

EP23) Actual experience in each reporting period is likely to differ from expectations. Such variances should be recognised during the reporting period in which they occur.

EP24) When reviewing assumptions, all relevant information should be taken into account, including both external market data and internal experience.

EP25) Assumptions should be updated symmetrically, taking into account both positive and negative changes in anticipated experience.

BC34) The measurement of *insurance liabilities* is most relevant when it reflects up-to-date assumptions about the future. This applies equally to the *best estimate* of future cash flows and the allowance for risk and uncertainty.

Financial and non-financial assumptions

EP26) Financial assumptions should be based on market information where available and reliable. Otherwise, financial assumptions should reflect management's *best estimate* of the future consistent with any relevant market information.

EP27) Non-financial assumptions should be changed when actual experience indicates that the current assumptions are unlikely to be sustainable. Non-financial assumptions should reflect management's *best estimate* of the future.

EP28) To the extent there are interdependencies between assumptions, the corresponding impact of these interdependencies should be taken into account when updating assumptions.

BC35) Most financial assumptions are either taken directly from market prices or indices or are determined by reference to market prices and indices. At each *valuation date*, the assumption is updated in line with the market value or reference point.

BC36) Non-financial assumptions are typically not determined by reference to market prices. Although market information may be available, this requires interpretation in the context of the insurer's business. Wherever possible, insurers rely on their own data as the most appropriate basis for deriving assumptions. Even non-financial market information is comprised of relatively

small volumes of data compared with the extensive data available in a liquid financial market. Consequently the data on which assumptions are based can be subject to volatility.

BC37) From one reporting date to the next it is expected that actual experience will differ from the assumptions due to random variations. It will not be immediately apparent whether the actual experience is fluctuating around the original assumption or whether there is an underlying change in experience that invalidates the original assumption. Management may monitor assumptions at a number of reporting dates before they conclude that there is evidence that the previous assumption needs updating. It would not be appropriate for assumptions relating to future cash flows to be changed at every *valuation date* due to random variations in actual experience in the intervening period.

Impact of updated assumptions on liability measurement

EP29) At the end of each reporting period, the value of the *insurance liability* and the *risk profile* are reassessed. Changes in future assumptions, both financial and non-financial, may affect the *best estimate* liability, the allowance for inherent risk and uncertainty and the total margin.

EP30) For pre-claims liabilities, consistent with Principles A and H:

- the impact of changes in financial assumptions should be recognised in line with the treatment of the market value of assets; and
- the impact of changes in non-financial assumptions, either adverse or favourable, should be recognised through release over the future *risk profile* of the contract.

The overall *insurance liability* should be subject to a liability adequacy test.

EP31) For post-claims liabilities, changes in future assumptions should be recognised immediately.

BC38) Total margins are adjusted to reflect changes in the present value of the *best estimate* of future cash flows. The effect of this adjustment is that the result of the changes to the present value of future cash flows are recognised in line with future release from risk, subject to the liability adequacy test.

BC39) Principle H aims to achieve consistent measurement of financial assets and *insurance liabilities*. Movements in the value of *insurance liabilities* due to changes in financial assumptions will be hedged by movements in the financial assets backing those liabilities. In consequence, changes in both liabilities and assets resulting from changes in financial assumptions are recognised in a consistent way. The amount of margin at each subsequent *valuation date* should only be adjusted for changes in the value of *insurance liabilities* arising from changes in non-financial assumptions.

Other key features for *Insurance Contract Measurement*

Unit of account

C. Measurement should be based on a portfolio basis.

BC40) Management of insurance risk is based around pooling risks. At inception, the outcome for one *insurance contract* is extremely uncertain. It may suffer no insured event or it may suffer extreme adverse experience. If this contract is considered not as a single contract but as part of a pool of many contracts giving rise to similar risks, the expected outcome on all those contracts can be more reliably predicted. The larger the number of similar contracts considered together, the more reliable the result.

BC41) The reasons for using the portfolio as the unit of account include:

- the accounting is aligned with the management of the business and hence relevant to external users;
- the ability to reflect the average policyholder behaviour for the portfolio;
- a portfolio provides a more appropriate basis for calculating margins for risk and uncertainty than an individual contract, because of the 'law of large numbers' (this is consistent with the pricing basis, which, in turn, reflects the size of the portfolio into which the individual contract is placed); and
- the recognition of the ability to aggregate profits and losses within the portfolio under liability adequacy tests.

Definition of portfolio

EP32) **A portfolio is a group of contracts that are managed together when assessing risk. A portfolio may include one or many contracts, but typically will comprise many contracts reflecting the pooling of risks inherent in the insurance business model.**

EP33) **For measurement purposes, the portfolio should be the unit of account. The portfolio basis should reflect internal management strategy. The basis of management may not necessarily be uniform across a group of insurance operations.**

EP34) **Portfolios should be defined and measured on a consistent basis in successive reporting periods.**

BC42) For the purpose of valuation of liabilities, a portfolio of contracts is a group of contracts that are managed together. This should be determined by reference to how management operates the business. Indicators that a group of policies are managed together might include, for example:

- Consistent pricing or underwriting strategy;
- Internal management reporting bases;
- Capital management;
- Reinsurance strategy.

BC43) The portfolio basis does not remove the risk of aggregate exposures nor the possibility of taking into account diversification benefits arising from different portfolios that are not affected by the same risks. The aggregation of allowances for inherent risk and uncertainty calculated for each portfolio is subject to further consideration.

BC44) On a portfolio basis, it is unlikely that all policies will surrender simultaneously and thus the imposition of a deposit floor is inappropriate. As explained under Principle D, the CFO Forum believes that the measurement of the liability calculations allows for surrender risk and therefore further margins are unnecessary.

Policyholder behaviour

D. Policyholder behaviour, including *recurring premiums* and lapses, should be reflected in the measurement of liabilities. Renewal options or provisions that obligate the insurer to continue to provide coverage should be recognised to the extent they are included in the contract.

BC45) There are two different types of *renewal premiums*. Future premiums that form part of a contract (*recurring premiums*) and premiums paid for a new contract (*renewal premiums* e.g. on a motor policy). In addition, renewal options occur where the insured has the right to renew the current contract with or without underwriting or re-pricing.

BC46) Both renewal options and *recurring premiums* need to be reflected in the measurement of liabilities. However, *renewal premiums* for a new contract, which can be underwritten and re-priced, should not.

BC47) The occurrence and amount of different payments (claim, maturity, surrender, paid up) are contingent on the payment of premiums. Equally, the payment of *recurring premiums* is contingent on the non-occurrence or occurrence of insured events or policyholder lapses. It is not possible to consider one element of the cash flows without considering the impact on all other elements.

BC48) Further, for some risks, notably life and health cover, the risk of a claim increases over time, while the recurring annual premium is usually kept level throughout the term. As a result, in the later stages of a contract, the policyholder continues to renew because it would not be possible to obtain the same cover for the same premium under a new contract. In this manner, the payment of *recurring premiums* is related to the level of cover yet to be provided.

Recurring premiums

EP35) **The cash flows included in the estimate of the *insurance liability* should only include cash flows associated with the current *insurance contract* and any existing *ongoing obligation to service policyholders*. This should not include expected renewals that are not included within the current *insurance contract*.**

EP36) ***Recurring premiums* should be included in the determination of future cash flows, with an assessment of the future persistency based on actual experience and anticipated future experience.**

BC49) Policyholders' decisions to lapse policies or take renewal options are based on a wide range of factors, such as personal circumstances and preferences, or institutional factors (e.g. changes in tax treatment, changes in regulations and legal changes) and the financial consequences of the decision being

taken. Although it may be in all policyholders' financial interest, under certain economic conditions, to lapse their policy and purchase a new one, in practice many policyholders will continue with their existing policies, perhaps because they would not be able to obtain a similar policy on the same or better terms, for example, due to impaired health. Similarly, policyholders' decisions on whether to take up a guaranteed renewal option will depend on not only the financial aspects of the guarantee but also on their personal circumstances, for example, whether they need that type of policy and whether they would be able to obtain an alternative policy.

BC50) Most current insurance accounting approaches include all cash flows from the current contract in the measurement of the liability. As a contractual relationship exists between the insurer and the policyholder, the contract will normally be amended if premiums are not paid, so it is appropriate to include all future cash flows expected to arise during the current contract term.

Renewal options

EP37) Where a contract includes options or guarantees that provide rights under which the policyholder can obtain a further contract on favourable terms (for example, renewal with restrictions on re-pricing or further underwriting) then the value of these guarantees and options should be included in the evaluation of the *insurance liability* arising under the existing contract. Where no such restrictions on re-pricing or underwriting exist, there is no *ongoing obligation to service policyholders*.

BC51) Insurers issue some contracts that include the option to increase or renew insurance coverage. Under these contracts, the value of the option varies in line with the insurer's ability to re-underwrite the risk or change the premium. Under other contracts, the insurer is constrained in its ability to adjust the terms of the option. Where an insurer has the ability to re-underwrite risks fully, on a policy-by-policy basis, it is likely that the option will have zero value. Where there is limited ability to re-price, for example, the current rate for new business must be charged for renewals, there will be some potential cost. Options to effect additional insurance on fixed terms are likely to give rise to the most onerous additional cost.

BC52) Such renewal options should be valued as a cost arising during the term of the current contract and included in the measurement of the liability. The valuation approach may involve projecting the additional future cash flow arising from the option. However, this projection is aiming to establish a cost, not bring forward cash flows from future contracts.

BC53) The CFO Forum Principles state that profit should be recognised as the insurer is released from risk. The risk from second and subsequent contracts is only released as service under the future contracts is provided. Therefore, any profits from renewal options should not be recognised during the current contract. Recognition of profit from renewal options should take place at the end of the current contract if the option is not exercised, otherwise, during the ensuing contract period.

Margins for risk of withdrawal

EP38) The likelihood of withdrawals should be included in the *insurance liability* measurement including a margin for risk and uncertainty. Therefore the use of further margins is unnecessary and hence no deposit floor should be applied.

Options and guarantees

E. Liabilities should include the value of options and guarantees.

BC54) The CFO Forum considers the inclusion of all options and guarantees as necessary to reflect the economic reality of the business being written and to be consistent with the management of the business.

Measurement of options and guarantees

EP39) Options and guarantees should be included in the measurement of the liability reflecting both their *time value* and *intrinsic value*.

EP40) In *insurance contracts* the financial and non-financial components of options and guarantees are linked and interdependent. Accordingly, where no active market exists, the value of the option or guarantee should be determined using a valuation technique. The financial and non-financial elements of the option and guarantee should be evaluated together.

EP41) In line with Principle D, the valuation of options and guarantees should take account of expected policyholder behaviour.

BC55) The valuation of *insurance contracts* should reflect the value of all options and guarantees. In practice, many options and guarantees in *insurance contracts* are hybrids containing both financial and non-financial elements, which are interdependent. Typical approaches are to build a valuation model that applies stochastic techniques. This includes all financial parameters, non-financial parameters and policyholder behaviour building on the associated cash flows arising from the non-financial assumptions. Such a model is capable of allowing for the interdependency of the financial and non-financial elements.

BC56) The value of options and guarantees depends upon their unique characteristics and is interdependent with cash flows arising from the *insurance contract*. In order to evaluate appropriately the liability arising from an *insurance contract*, the valuation basis should consider potential cash flows arising from all components of the *insurance contract* and the interdependencies of those components. The valuation model should consider options and guarantees as part of the overall valuation.

Own Credit Risk

F. The credit standing of an *insurance contract* should not be considered in the valuation of *insurance liabilities*.

EP42) The assumptions and methodology used in the valuation of *insurance liabilities* should take no account of the credit standing of the *insurance contract*.

- BC57) The CFO Forum sees informational advantages to investors and analysts in presenting the liabilities as risk free so that the full extent of the liabilities is transparent. Moreover, introducing credit standing would result in an accounting profit in the event of the downgrade of an insurer, which is considered misleading.
- BC58) The insurance industry regulators require substantial safeguards to protect policyholders' rights, which ensures it is rare for a valid claim not to be paid in full by a solvent insurer. As a result of regulatory oversight, and basic accounting principles, it follows that treating the insurer on a going concern basis excludes consideration of the credit standing.
- BC59) In many jurisdictions, any transfer of policies between insurers is subject to the approval of regulators and will not be allowed if the transfer would be against the interest of the policyholders. Therefore, the transaction price would not take the credit risk of the insurance company into account unless in default circumstances. This means that a company that is a going concern cannot realise a gain on own credit risk by transferring a portfolio of policies to a third party.
- BC60) It may be a practical expedient to accept that some premiums reflect the net effect on the credit standing of the insurer but it is not practical to follow through every resulting change in credit standing when the movements in credit standing do not affect the liability.

Participating contracts

G. A principles based approach to participating contracts should be adopted reflecting the different models of discretionary participation in different territories.

The CFO Forum has considered participating contracts and believe that the same Principles outlined for non-participating contracts should apply. Participating contracts are an extremely important part of the business written by insurance companies and it is therefore essential to understand how these principles would apply to participating contracts. To enable this, the addendum to this document discusses how these principles should be applied to participating contracts.

- BC61) Participating contracts include different discretionary benefits in each territory, reflecting the various national, legal and accounting practices that exist across the world. While international accounting standards may seek to find a common approach to the reporting of these systems, the CFO Forum believes that any standard should be based on broad principles. These principles should provide a relevant balance between the different legal and regulatory environments and the economic nature of the obligations.

2) Asset and Liability Consistency

H. Assets and liabilities should be measured on a consistent basis reflecting the way that companies manage risk.

BC62) Accounting mismatches occur if assets and liabilities, both generated by the same contracts, are measured on a different basis. Changes in economic conditions may lead to artificial gains or losses, even when the assets and liabilities are economically matched.

BC63) Economic mismatches arise if values of assets and liabilities, both generated by the same contracts, respond differently to changes in economic conditions.

BC64) Principle H recognises the importance of asset liability management within the insurance business model. The Principle seeks to eliminate or significantly reduce an accounting mismatch, but does not seek to eliminate the recognition of an economic mismatch in the financial statements.

BC65) In current insurance accounting models, accounting mismatches arise when the *insurance liabilities* are valued at historical value, whilst assets backing those *insurance liabilities* are valued at fair value.

BC66) An accounting model that measures both assets and liabilities at amounts based on current financial conditions would reflect the degree of economic mismatch of the entity.

EP43) Financial assets and *insurance liabilities* should be measured based on current financial conditions. Changes in value should be recognised in a consistent way.

BC67) As stated under Principle B, the CFO Forum believes that it is appropriate for the *insurance liability* to be discounted to reflect the *time value* of money. For non-performance linked contracts the appropriate discount rate is the risk free rate of return specific to the liabilities being measured.

EP44) As noted above, where the value of the *insurance liability* is linked, contractually or through other legal or regulatory terms, to the value of associated assets, the value of the *insurance liabilities* is calculated with reference to the market value of the assets at the *valuation date*.

EP45) The impact of changes in financial assumptions should be recognised immediately and the impact of changes in non-financial assumptions should be recognised through the release over the future *risk profile* of the contract.

BC68) Principle H may result in volatility as financial and non-financial assumptions vary. However, such volatility does not imply that the measurement bases of the assets and liabilities are inconsistent if this reflects an economic, not an accounting, mismatch.

3) Value-based Reporting

I. Value-based measures may be disclosed as supplementary information. The basis of the value-based measure should be disclosed.

BC69) The CFO Forum believes that there are different measures of financial performance that are equally valid but communicate different information to investors. The relevance of the accounts to investors would be reduced if value based measures were excluded from supplementary reporting or company financial reporting statements.

Relevance of value-based reporting

EP46) Value-based measures are considered to be important by many users of accounts such as investment analysts. They provide a measure of expected value creation from sales of new business in the current reporting period and from maintenance of the in-force book of business.

EP47) The European Embedded Value (EEV) Principles are the CFO Forum's preferred basis for reporting value-based results, particularly for life insurance business; however, other measures should be permitted as long as they are adequately explained.

BC70) Value-based measures are intended to provide relevant information to users of accounts on the expected value and drivers of change in value of a company's existing business, as well as risks associated with the realisation of that value. The primary measure is the expected value of future cash flows distributable to shareholders from the business.

BC71) Information provided should allow the users to understand management's views of the value and changes in value of the shareholders' interest in a specified part of the company's business, together with the main events influencing them during the reporting period.

BC72) Value-based reporting information reflects management's view of the future profitability of current business in-force and new business in the reporting period. It provides a reflection of the value and underlying drivers of performance.

BC73) As set out in Principle A, the CFO Forum believes that recognising profits in line with release from risk is the most appropriate basis for primary reporting. Additionally, it is important that companies should retain the ability to report value-based measures as supplementary information, since this provides valuable information to the users of accounts.

BC74) The future profit streams assumed confer useful information to the users, but are not appropriate as the primary accounting basis.

Defined Terms

Best estimate	<p>The probability weighted average also referred to as the mean.</p> <p>This term is used to apply in many circumstances relating to the valuation of <i>insurance contracts</i>, including to an asset or liability, a cash flow stream, an individual assumption or a valuation approach.</p>
Initial acquisition costs	All costs associated with procuring the <i>insurance contract</i> , including direct and indirect marketing and sales costs and related overheads.
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 liability	An insurer's net contractual obligations under an <i>insurance contract</i> .
Intrinsic value	The present value of the <i>best estimate</i> of future cash flows arising from the obligation to pay future benefits and expenses arising from obligations to pay future options and guarantees under an <i>insurance contract</i> , including obligations under policyholder participation features.
Ongoing obligation to service policyholders	The obligation that arises when an entity may be required to settle a liability on the occurrence or non-occurrence of a future event. A liability may arise from the obligation to pay a claim that has not yet been incurred or pay additional benefits or receive reduced income as a consequence of a policyholder exercising an option or guarantee.
Recognition period	The period from initial recognition of an asset or liability over which the measured value is assessed in line with the characteristics of that asset or liability and, in the case of assets, for impairment or inability to collect.
Recurring premiums	A repeat premium (often monthly) paid to ensure the continuation of an existing contract.
Renewal premiums	This term is typically used to refer to both premiums paid to ensure continuation of an existing contract and premiums paid to put in place a new contract that replaces a previous contract. For clarity, in these Principles we have defined the former as <i>recurring premiums</i> .

Risk profile	A measure of the perceived risk and uncertainty inherent in the contract at every <i>valuation date</i> between inception and settlement of any claims arising under the contract.
Time value	The estimated future value of a contractual promise, for example, an option or guarantee. <i>Time value</i> takes into account the likelihood and amount that an option or guarantee will confer a valuable benefit to a policyholder at some point in the future when it can be exercised.
Valuation date	The date at which an entity is evaluating its <i>insurance liabilities</i> and assets, typically the financial reporting date.

**CFO Forum
Elaborated Principles for an
IFRS Phase II Insurance Accounting Model**

**Addendum:
Clarification of the Elaborated Principles
in respect of Participating Contracts**

CFO Forum

Elaborated Principles for an IFRS Phase II Insurance Accounting Model

Introduction

The purpose of this document is to set out the views of the CFO Forum in relation to participating contracts and to provide relevant additional elaboration of the Principles and supporting Basis for Conclusions information. This document should be read as an addendum to the general Elaborated Principles and Basis for Conclusions document. Any areas where there are differences between the approaches proposed for participating contracts guidance and the general Elaborated Principles are noted in this document.

Participating contracts include different discretionary benefits in each territory reflecting the various national, legal and accounting practices that exist across the world. While international accounting standards may seek to find a common approach to the reporting of these systems, the CFO Forum believes that any standard should be based on broad principles. These principles should provide a relevant balance between the different legal and regulatory environments and the economic nature of the obligations.

The headings used within the sections below correspond with the section headings used in the Elaborated Principles and Basis for Conclusions document.

Scope of this document

These additions to the Elaborated Principles are applicable to insurance and investment contracts with discretionary participation features as defined in IFRS 4, and also to other insurance and investment contracts that contain benefits that are under the discretion of management. The discretionary amounts may relate to either the amount or timing of the cash flows or both. Hence forth, we will refer to these as 'Participating Contracts'.

The discretionary participation features of insurance and investment contracts are often very similar and should be accounted for consistently.

Participating Contracts should, in general, follow the Elaborated Principles. This document provides areas of guidance in addition to that in the general Elaborated Principles.

A. Accounting profit should be recognised in line with the release from risk.

Risk profile

EPP1) The *risk profile* of a Participating Contract should be assessed from the viewpoint of the insurer rather than the policyholder. The *risk profile* should reflect the fact that risk is shared between the insurer and the policyholders.

BC1) The viewpoint of the insurer relates to that of the owners, which, for a stock company, would be the shareholders.

B. The liability should be based on the present value of all future cash flows with allowance for the inherent risk and uncertainty. The cash flows should reflect management's *best estimate* of the future.

Best estimate

EPP2) For Participating Contracts, the *insurance liability* should include all anticipated future payments to policyholders. This would include guaranteed benefits and expected future additional benefits.

EPP3) The present value of future benefits should be consistent with management's application of its discretion on the portfolio of contracts as a whole.

BC2) At a portfolio level, insurers can be obliged to distribute a certain level of benefits. The insurer faces an effective obligation in relation to the benefits payable on the contracts as a portfolio.

EPP4) For many Participating Contracts the benefits under those contracts are based on accounts not prepared in accordance with IFRS, for example local GAAP accounts or regulatory accounts. To the extent that there are differences in valuation of assets and liabilities between IFRS accounts and such accounts, the portion of this difference that would be attributable to policyholders should be included in the measurement of the *insurance liability*.

BC3) In some jurisdictions, benefits to policyholders of participating contracts are based on the regulatory accounts. The distribution may be governed by legal, contractual and other regulatory constraints as well as by the management's discretion to distribute additional benefits. In this case, the *insurance liability* under IFRS accounts will be composed of two components: a liability for guaranteed amounts, including the participation of policyholders, which relates to past regulatory accounts, and the policyholder's participation in temporary valuation differences between the carrying amount of assets or liabilities in the statutory accounts and their valuation basis in the IFRS accounts. The latter reflects the future additional benefits, which would be expected to be attributable when the assets were to be realised or the liabilities were to be settled. In this case, accounting for expected future policyholder additional benefits is similar in some respects to the treatment of deferred taxes.

EPP5) In some circumstances, Participating Contracts are maintained in a ring-fenced fund. For these Participating Contracts, the best estimate liability of the insurer will reflect the amounts expected to be paid to policyholders by reference to the distribution basis of the fund. This would include the liability based on the income and expense in respect of the policies and an amount in respect of the distribution of assets in excess of such liabilities attributable to policyholders.

BC4) In some jurisdictions, the assets and liabilities of Participating Contracts are required to be maintained in ring-fenced funds to which the rights of distribution between policyholders and shareholders are governed by the company's constitution or other legal arrangement. In such circumstances, the company has control over a fund which is consolidated into its accounts but to which shareholders have no rights of access other than through the basis of distribution. Typically, the distribution basis solely reflects the bonuses allocated to policyholders.

EPP6) Where there are restrictions over shareholder access to the excess of assets over liabilities in ring-fenced funds, these amounts should be recorded as a liability of the insurer and earned as distributions are made to shareholders.

BC5) For those funds for which there are restricted rights of shareholder access as described above, it is appropriate to consider the accounting treatment of the excess of assets over liabilities (including liabilities for undistributed policyholder allocation). In such circumstances, these amounts, to the extent not allocated to shareholders through legal arrangement, are neither liabilities attributable to policyholders or surplus attributable to shareholders. Consistent with the basis of distribution and restrictions over access, these amounts should be recorded as a liability of the insurer and earned as distributions are made to shareholders.

EPP7) Management's assessment of future additional benefits should be consistent with an assumption that the expected total return on assets is based on current risk-free rates of return. In some cases, there are appropriate proxies to determine the present value of future discretionary cash flows from the *insurance contract*. Where such methods are expected to yield a reliable assessment, these may be used. For example, a retrospective accumulation of policy cash flows may be used to assess the value of the liability.

Economic losses/Liability adequacy test

EPP8) The assessment of economic losses at inception and any liability adequacy test at subsequent reporting dates should be based on the management's estimate of future additional benefits, consistent with the economic scenario assumed. The assessment of economic losses should take account of the ability of the insurer to adjust additional benefits in the event of adverse scenarios.

BC6) In applying EPP8, the extent to which management is able to exercise discretion may be limited by contractual terms and/or statutory regulations.

BC7) To the extent that an adverse scenario has already occurred, a loss needs to be recognised to the extent that the effect cannot be covered by management action of reduced future benefits.

C. Measurement should be based on a portfolio basis.

Unit of account

EPP9) The definition of a portfolio for Participating Contracts should reflect the level of aggregation used within the assessment for policyholder bonus rates.

E. Liabilities should include the value of options and guarantees.

Options and guarantees

EPP10) The value of future options and guarantees should allow for future management actions to the extent that the actions will affect future cash flows.

BC8) Options and guarantees include those in relation to the future expected discretionary benefits. The granting of future discretionary benefits, followed by adverse market movements, may give rise to guarantee costs. To the extent that there are constraints on the management's option to adjust the timing or amount of future expected additional benefits, these guarantee costs should be reflected in the liability.

H. Assets and liabilities should be measured on a consistent basis, reflecting the way that companies manage risk.

Asset and liability consistency

BC9) Participating Contracts are often linked to the value of the assets backing the business. Where appropriate, the value of future liability cash flows should be consistent with the market value of assets.