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Project      **Insurance contracts**

Topic        **Field Testing**

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### Staff note

**This paper on field testing has the same content as agenda paper 10E for the June 2009 IASB and FASB meetings. The questions for participants on candidate measurement approaches are included in agenda paper 8 for the June 2009 Working Group meeting**

### Purpose of this paper

1. This paper includes the staff's recommendations for field testing the proposals in the Insurance Contracts Project and asks the boards for high level comments on the approach and timing.

### Summary of staff recommendations

2. Staff propose:
  - (a) a targeted field test
  - (b) main activity conducted prior to issue of exposure draft (ED)
  - (c) conclusions supported by observable and measurable evidence
  - (d) inclusion of cost-benefit considerations
  - (e) participation of 15 insurers (preparers)
  - (f) involvement of user groups (topics and timing to be decided).

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This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board. Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

### Why field testing?

3. Staff believe that field testing will help the boards to:
  - (a) assess whether their proposals achieve the project objectives
  - (b) understand how the proposed approach will change current practice
  - (c) assess the implementation timetable
  - (d) identify where more detailed implementation guidance may be needed
  - (e) evaluate the costs and benefits of the proposed approach.
4. Many respondents to the discussion paper (DP) *Preliminary Views on Insurance Contracts* recommended that the IASB work closely with the insurance industry to field test its key proposals with insurance product data. They thought this was important due to:
  - (a) the fundamental nature of the changes proposed in Phase II
  - (b) the broad range of contracts to which the model will be applied
  - (c) the accounting complexities of the insurance sector.
5. Members of the Insurance Working Group (IWG) also requested that field testing be carried out.

### What type of field test?

6. The main objectives of field testing the Insurance Contracts project proposals are:
  - (a) to test proposals and get input from our constituents on whether they:
    - (i) result in a faithful representation of insurers' financial position and performance
    - (ii) can be applied rigorously and consistently in practice
    - (iii) provide workable and auditable solutions

- (b) to collect observable and measurable evidence that supports conclusions
  - (c) to consult interested parties prior to the issue of an ED and final standard.
7. We considered two types of field test to achieve these objectives:
- (a) A comprehensive test of a complete set of proposed accounting requirements, probably conducted on one occasion.
  - (b) A targeted test of specific topics, carried out at various times during the project as issues arise.
8. Staff recommend a targeted field test approach which, being flexible and focused, will enable proposals to be tested as they evolve and the results fed back promptly. This approach also minimizes the risk of delay to the project timetable.
9. The advantages of having information and experience available as a result of other field tests and similar activities, such as those itemized in paragraph 27, also reduces the need for comprehensive field testing.

**Question 1**

Do you agree that field testing is necessary before we develop an ED on Insurance Contracts? If so, do you agree that a targeted field test is the most feasible option?

**Timing of field testing**

10. Staff recommend that the main field testing activity is conducted prior to the issue of an ED to assist Board members in their deliberations and to allow for any findings to be incorporated.
11. Staff propose that field testing starts shortly after the boards have made a tentative decision on the measurement approach, currently scheduled for July 2009.

12. We believe it would be difficult to test a particular measurement approach thoroughly before it has been specified in sufficient detail. The following factors are relevant:
- (a) Field testing may involve significant cost for participants, for example, to implement systems changes which should not be incurred prematurely.
  - (b) Participants may be reluctant to commit significant resources to testing an incomplete proposal that could differ significantly from the final proposal.
13. In the current timetable an ED is expected to be published in the first half of 2010. There is therefore limited time in which to seek out and analyze participant feedback after factoring in time for completion and drafting of the ED. A targeted field test, coupled with the output and experience gained from other activities (such as those identified in paragraph 27) meets the test objectives without risking delays to the project.
14. Staff recognize, however, that it is important to manage expectations of what can be achieved in this time frame and note that additional field testing may be required after the ED has been published, in the period up to the completion of a final standard.

**Question 2**

Do you have any comments on the proposed timing of the field testing?

**Nature of targeted field test**

***Field Test design***

15. Participants will be asked to answer questions on specific topics (examples included in paragraph 25) and, if possible, to design their own tests to support their conclusions using internal modeling techniques and financial data.

16. The instruction pack provided to participants in advance of the field test will include guidelines on the timetable, test methodology, and how to provide feedback to support conclusions. We do not propose distributing prescribed actuarial spreadsheets or literature; we want participants to focus on how the principles in the proposals may be applied in practice.
17. We will ask questions that request participants to provide, where practicable, observable and measurable evidence that supports conclusions, rather than conceptual statements about, for example, why the proposals may not work in practice. We want to hear about any difficulties of course, but by focusing on specific topics and requiring results based on real experience and quantitative data, the output will, we hope, be targeted and will reflect tangible implementation issues.
18. Staff aim to understand:
  - (a) the current basis of accounting
  - (b) incremental costs and benefits of moving to the new approach
  - (c) obstacles affecting application of the proposed approach
  - (d) whether the proposed approach is operational for an entity with a reasonable level of knowledge and sophistication, using information that is currently available or that can be created.
19. We expect that some participants will already have considerable experience in some areas, for example in estimating future cash flows and will not need to do much additional testing to support their conclusions. Others may have less experience and will need to do more testing to assess the effect of the proposals.
20. To maximize the value of the tests carried out, staff propose that test conclusions are made widely available, subject to protocols to be developed to deal with confidentiality and any securities regulatory concerns.
21. Staff recommend supplementing the field testing activity with field visits, which may be conducted:

- (a) during the field test to discuss matters related to the process and to monitor progress
- (b) after the field test to discuss test results, obtain participants' feedback on the activity and follow up on outstanding issues.

***Cost-benefit considerations***

- 22. The cost-benefit implications of transitioning to a new approach is especially important as the Insurance Contracts project is expected to introduce significant changes in practice.
- 23. Participants will be asked to make an assessment of both one-time costs and ongoing costs associated with the proposals. Such costs may include:
  - (a) costs to understand the new requirements (eg training)
  - (b) costs to collect, process and analyze new information (eg systems changes)
  - (c) costs associated with disclosure of proprietary information (competitive advantages/disadvantages).
- 24. Benefits associated with a new standard may include:
  - (a) increased credibility and representational faithfulness of financial reporting (ie benefits associated with maintaining and increasing the credibility of financial statements, which is critical to investor confidence)
  - (b) improved financial processes resulting in better pricing, risk and capital management.

It may be difficult for participants to quantify such benefits, although we think there is value in identifying what the benefits are.

***Topics to be tested***

- 25. The following topics may be suitable candidates for field testing:

- (a) estimation of cash flows (focusing on those aspects of cash flow estimation that are likely to depend on the particular approach tested, rather than aspects that are likely to be common to most feasible approaches)
- (b) determination of discount rates
- (c) determination of risk margins
- (d) other application issues of the measurement approach
- (e) treatment of acquisition costs
- (f) features of participating contracts
- (g) investment contracts
- (h) the effects of policyholder behaviour, including boundaries of existing contracts.

**Question 3**

Do you have any high level comments on the topics recommended for field testing in paragraph 25?

***Other sources of information***

- 26. Field tests may involve significant cost, for example, to implement systems changes necessary to apply the proposed approach. Targeted field testing should ideally use as much information as possible that is already available to participants or obtainable reasonably easily.
- 27. Such information might include:
  - (a) information gained by participants in field tests organized by regulators, for example the Quantitative Impact Studies (QIS) carried out in Europe for Solvency II.
  - (b) information generated by public studies organized by actuarial and trade associations.

- (c) information generated as a result of internal work carried out by individual companies or consultants, such as the development of economic capital models.
  - (d) experience gained by insurers in developing and utilising models such as those for Market Consistent Embedded Value.
  - (e) experience gained by users in applying models, such as those used by rating agencies and equity analysts.
  - (f) experience gained in countries where national GAAP contains some elements that are similar to features of the approach being tested.
28. On completion of field testing staff will be able to compare its assessment of the field test results with other similar tests.

## **Selection of participants**

### ***Preparer groups***

29. Staff propose a test group of 15 insurers, which is a manageable number that still allows for some diversity. Staff suggest the following selection criteria for participants:
- (a) geographic spread (which determines the regulatory and financial reporting environment)
  - (b) diversity of line of business (life, general, health and reinsurance)
  - (c) some mutual companies
  - (d) size, so that smaller and medium sized insurers are represented
  - (e) willingness and ability to participate (eg sufficient resources).

### ***User groups***

30. A primary benefit of a new standard is its information content. A new Insurance standard should lead to clearer and more transparent and comparable

information about performance, risk and capital that is useful in making business and economic decisions. Many analysts currently believe that multiple reporting bases in the insurance sector make it difficult to compare entities' financial performance.

31. Preparers are focused on how proposals are applied. Users focus on analyzing and interpreting the information required by proposals. In order to fully understand and balance the needs of users and preparers, staff recommend that the user community is invited to participate in field testing to:
- (a) gauge their understanding of the new proposals
  - (b) ensure that the proposals meet their need for consistent measurement of insurance liabilities across entities reporting under IFRS
  - (c) seek their feedback on the decision usefulness of the proposals.
32. We are evaluating which topics to include in a field test with user groups and the most appropriate timing.
33. It has been useful in other projects to facilitate joint meetings with preparers and users to help the boards better understand the costs and benefits of proposals. The Insurance Working Group provides one forum for such meetings. The staff will keep under review whether we need other meetings of this kind.

**Question 4**

Do you have any comments or suggestions on the selection criteria for field testing participants?

**Question 5**

Do you have any further comments or suggestions on field testing?