30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **February 2009, London**

Project: **Insurance Contracts**

Subject: **Measurement Approaches (Agenda paper 10A)**

Purpose of this paper

1. At the October 2008 IASB meeting[1], staff presented a list of those measurement approaches that the staff views as viable candidates in the case of insurance liabilities. Staff also discussed the main features of the candidates and some considerations on selecting between the candidates[2]. These candidates are:

   (a) 1- Current exit value as proposed by the discussion paper *Preliminary Views on Insurance Contracts* (DP).

   (b) 2- Current fulfilment value including a risk margin reflecting the cost of bearing risk.

   (c) 3- Current fulfilment value as in candidate 2 plus an additional separate margin, calibrated at inception to the premium.

---

1 A similar educational session will be held with the FASB in February 2009.

2 October 2008, agenda paper 3.

(d) 4- Current fulfilment value including a single margin calibrated at inception to the premium (ie similar to candidate 3, but with one overall margin, not two separate margins).

(e) 5- Unearned premium (only for the pre-claims liability of short-duration contracts).

2. At this meeting, we present the following recommendations which will enable us to narrow down the range of measurement candidates for discussion at a future meeting:

   An insurer should measure insurance liabilities using an approach that:

   (i) uses estimates that are as consistent as possible with observable market prices.

   (ii) uses explicit current estimates of the expected cash flows, rather than locked-in estimates.

   (iii) reflects the time value of money.

   (iv) includes an explicit margin.

   (v) reflects the perspective that the insurer will fulfil the contract itself.

   (vi) does not result in the recognition of a positive day one difference (ie a gain) in profit or loss.

3. This paper considers some key aspects of measurement approaches 1-4; we will ask the boards to take decisions on those aspects. In this paper we will not ask the boards to select of one of the candidates from the list of candidates. The list of candidates presented in the October 2008 IASB meeting is included in agenda paper 10E for reference purposes.

4. Other aspects of a measurement approach will be discussed at future meetings, including the possibility of using of an unearned premium (candidate 5) for short-duration contracts. We will summarise these aspects in the next steps (paragraphs 45-46 of this paper). These aspects are in our view not critical to deciding on the key considerations that are discussed in this paper.

5. Furthermore, this paper does not deal with:

(a) Policyholder behaviour and policyholder participation.

(b) The attributes of the discount rate.

(c) Whether other comprehensive income (OCI) could be used for recognising some changes in insurance liabilities (see agenda paper 10F).

(d) Whether insurance contracts should be unbundled if the contract contains more than one component.

The features of a measurement approach

6. We believe that, in order to provide decision-useful information, the measurement of insurance contracts should:

(a) use estimates that are as consistent as possible with observable market prices. The use of observable market prices results in less subjective measurements.

(b) use explicit current estimates of the expected cash flows. Explicit current estimates reflect the inherent variability of cash flows from insurance liabilities better than locked-in estimates. Reporting on changes in circumstances each period provides more decision-useful information. Expected value results in an unbiased use of all available information.

(c) reflect the time value of money. Many insurance contracts have a long duration. By discounting, the measurement will represent the insurance liability more faithfully.

(d) include an explicit margin. Explicit estimates of margins ensure that financial reporting does not result in representing two liabilities as the same if one liability is more risky than the other. Furthermore, explicit estimates of margins are likely to result in insurers gaining a deeper understanding of the risks associated with the insurance contracts, leading to estimates that are more robust and a reduced risk of insurers overlooking changes in circumstances.

7. These features are also included in the building blocks proposed in the DP[3]. The features should, conceptually, be part of any candidate. We added 'conceptually' because one of the candidates (candidate 5) is based on an unearned premium approach as a simplification in some cases. This approach does not use the features mentioned in paragraph 6, although in some cases the result may be reasonably similar.

8. **Question for the boards.** Do you agree that the measurement approach for insurance contracts conceptually should include the features listed in paragraph 6?

9. On other features the candidates may vary, for example:

   (a) Differences relating to the principle for the measurement approach (transfer versus fulfilment), including:

      (i) estimates for which no observable market prices are available

      (ii) cash flows that arise from the characteristics of the entity

      (iii) credit characteristics.

   (b) Difference relating to margins and day one differences, including:

      (i) risk margins

      (ii) service margins

      (iii) day one differences, namely the difference between (1) the premium [possibly less relevant acquisition costs[4]] and (2) the expected present value of the cash flows plus the margin. We use the term 'day one difference' in order not to prejudge a discussion on this issue in one direction or the other[5].

[3] Memorandum No. 2 of FASB's January 9th educational session on the DP and the responses to the DP provides further information on these building block features. This information was provided to the IASB during its past meetings.

[4] We will come back to the issue of acquisition costs at a future meeting. An outcome of that discussion could be that the insurer uses the premium less acquisition costs for estimating the margin at day one.

[5] When using the term 'day one difference', staff is usually referring to the issue of a 'positive' day one difference; recognising a 'negative' day one difference in profit or loss (day one loss) is uncontroversial.

Current exit value – the proposed measurement approach of the DP

10. We see current exit value (candidate 1) as a reference point for our discussion on the candidates because it is the measurement approach proposed in the DP. Current exit value reflects the amount to transfer the remaining insurance obligations to a third party at the reporting date.

11. Current exit value will be similar, probably even identical, to fair value as defined in SFAS 157 *Fair Value Measurements* and expected to be defined in the IASB's forthcoming ED on fair value measurements. Both SFAS 157 and the IASB's fair value measurement project define fair value as current exit price; it would therefore be natural to proceed with this label for candidate 1. However, we refer to candidate 1 as current exit value throughout the papers for this meeting for reasons of convenience; for future meetings, if we need to refer to it, we will replace this label by 'current exit price'.

12. We would like to emphasize that choosing current exit value as a starting point does not reflect a preference.

13. The arguments for current exit value are:

    (a) It includes all the features mentioned in paragraph 6.

    (b) A notion based on transfer provides a clear measurement objective that gives a frame of reference (market consistency) for all estimates. It also provides a clear principle for which cash flows to include (once we have decided how to define the boundaries of the item we are measuring; a subject we will return to when we talk at a future meeting about policyholder behaviour, future premiums and participating contracts).

    (c) It is an attribute of the liability; some may view other candidates as the results of computations rather than as attributes. Furthermore, Phase C, Measurement, of the Conceptual Framework Project could conclude that measurements should always be attributes. Some believe that measurements should be attributes of the insurance liability because:

        (i) attributes provide coherent framework for resolving new and emerging issues.

(ii) using an attribute may make it easier to communicate with users. Users often complain that insurance accounting is a 'black box'.

(d) Most of an insurer's assets are measured at fair value under both IFRSs and US GAAP. Adopting the same measurement attribute for insurance liabilities would substantially reduce accounting mismatches and may more effectively reveal economic mismatches. Moreover, if current exit value and a competing notion (eg. fulfilment value) come up with identical or very similar answers, it may be more understandable to use one single label rather than two different labels.

(e) A basis other than exit notion, particularly a fulfilment notion, could result in recognising an entity's efficiencies at inception of the contract. Some believe that these efficiencies should be recognised as the entity realises them over time.

14. However, there are some arguments against current exit value:

(a) Insurers generally cannot or will not transfer the liability. Many respondents see current exit value as not relevant as it refers to a hypothetical transaction that does not reflect the way the insurance contracts are managed.

(b) Estimates of current exit value exclude entity-specific cash flows. However, most respondents to the DP believe that the most relevant measure of the liability uses the estimates and cash flows of the insurer for the following reasons:

(i) It would be unreasonable to require insurers to go to exceptional lengths to demonstrate that their own inputs are in line with the market. Moreover, it may be difficult to persuade auditors and regulators that the insurer has done enough work to confirm that its inputs are in line with those incurred by other market participants.

(ii) Insurers price contracts by reference to their own inputs. Thus, a measurement based on market-participant inputs could lead to a gain or loss at inception, which would reverse in later periods as the insurer provides the services.

(iii) It is generally not possible to observe directly what cash flows would arise for market participants. Moreover, any apparent differences between those cash flows

and entity-specific cash flows may arise from subtle and perhaps undetectable differences between the portfolios of, and products provided by the entity and the product and portfolios of other market participants. Thus, estimates of market participants' cash flows may be less robust than the entity's estimates of its own cash flows.

(iv) Differences between market participants' expenses and entity-specific expenses could also result from different levels of service provided and the approach to claims management. Adjusting the entity's own expenses could lead to inconsistency with other estimates like mortality and lapses.

(c) An exit notion of a liability reflects its credit characteristics. Most respondents reject this notion because it could lead to income or expense that they believe is difficult to understand; particularly when the liability is remeasured.

(d) The boards have tentatively rejected an exit notion in the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (DP on revenue). Some believe that measurement of insurance contracts should be as consistent as possible with that tentative decision. Some are particularly concerned about inconsistencies between the approach for insurance contracts and the approach for other services provided by insurers, such as fund management. Many life insurers offer fund management services both separately and embedded in insurance contracts.

An alternative – current fulfilment value

15. As a result of the arguments in the previous paragraph, many respondents to the DP indicated that current exit value would not lead to the most decision-useful information about insurance contracts. Many of them suggested a notion that reflects the fact that insurers almost always intend to fulfil the insurance contract with the policy holder over time themselves, rather than transfer it to another party for fulfilment. Their arguments for a fulfilment notion are, unsurprisingly, generally consistent with the arguments against current exit value [and, vice versa, the arguments for current exit value generally reflect concerns with a fulfilment value].

16. In the list of candidates, staff included three variants of a fulfilment notion (candidates 2-4). The tentative label for that notion is current fulfilment value. These candidates all

include the features mentioned in paragraph 6 but differ from current exit value in the features mentioned in paragraph 9, as discussed in the next section.

Differences between current exit value and the fulfilment candidates

17. Current fulfilment value would reflect the insurer's estimate of **the expected present value of the future cash flows** that will occur when the entity fulfils the insurance obligations with the policyholder over time. These cash flows would, in principle, include cash flows that are specific to the insurer. In contrast, current exit value excludes these entity-specific cash flows and reflects [the insurer's estimate of] the cash flows that would arise for a market participant. It seems uncontroversial that those cash flows will include at least the direct cash flows. But in order to fulfil the insurance liabilities, the insurer will also utilise indirect activities. Therefore, the cash flows are arguably more than just the direct cash flows. We will come back to guidance on cash flows at a future meeting.

18. Current exit value reflects the **non-performance risk** associated with the insurance liability, for both initial and subsequent measurement. The current fulfilment value candidates exclude non-performance risk, except to the extent that it is implied in the premium on day one. Arguably, current exit value and the current fulfilment value would therefore both reflect non-performance risk at inception of the contract (though they might get there through different routes). The biggest issue seems to arise for day two and onwards.

19. In relation to non-performance risk, it could be argued that the possibility of default reduces the burden of the insurer's obligation. Nevertheless, including the credit standing for (at least) subsequent measurement received significant opposition from respondents to the DP. Some argued that non-performance risk is not relevant for a measurement that reflects the insurer's expectation that it will fulfil its performance obligation over time. Others mentioned that, in practice, its effect is likely to be limited because of credit enhancements to the insurance liability by, for example, regulatory frameworks. We will come back to this during a future meeting.

20. **Margins and day one profits** for the fulfilment candidates differ from current exit value in estimation of the margins and treatment of day one differences; the fulfilment

candidates also differ from each other in this area. Agenda paper 10B describes how the margin and day one differences work for each candidate. We now summarise the differences between current exit value and each of the fulfilment candidates.

(a) Current exit value includes a risk margin and a service margin (if any) required by market participants. A day one difference can occur. If so, it is recognised in the income statement. The margin is remeasured at each reporting date.

(b) The fulfilment candidates (candidate 2-4) measure the risk margin from the entity's perspective. However, as agenda paper 10B explains, candidates 2 and 3 and current exit value could apply similar techniques to estimate the risk margin that may end up in similar answers in some, perhaps many, cases.

(c) Candidate 2 includes a risk margin but not a service margin. As a result, the day one differences for candidate 2, which are recognised in the income statement, may be higher than for current exit value. The risk margin in candidate 2 is remeasured each reporting date.

(d) The total margins for candidates 3 and 4 are initially measured by using the actual premium. The margin for candidate 4, a 'composite margin', uses the premium as the basis for determining the total margin at inception. In contrast to candidate 4, candidate 3 makes a split between a risk margin (the same as in candidate 2) and an additional margin.

(e) The additional margin of candidate 3 and the composite margin of candidate 4 include an implicit service margin. The service margin is recognised as the insurer fulfils its performance obligation to the services required by the contract, and is not subject to remeasurement. Candidate 1 includes an explicit service margin, remeasured at each reporting date.

(f) Candidates 3 and 4 do not recognise a day one difference in profit or loss.

(g) As a consequence of calibrating directly to the premium, candidate 4 requires a liability adequacy (onerous contract) test at inception since the premium may not be sufficient to cover the obligations [a liability adequacy test is not required subsequently because candidate 4 builds on the rationale that no subsequent

information will provide better evidence of the margin and all other building block elements are remeasured]. The other fulfilment candidates and current exit value do not require a liability adequacy test.

What should the measurement objective for insurance liabilities be?

21. Based on the considerations in the previous sections, we identified three views on the measurement objective for insurance contracts.

22. **View A.** Current exit value provides a clear principle and thus leads to the most decision-useful information. This fact should prevail over consistency with the measurement objective of the revenue recognition project. Current exit value and current fulfilment value may come up with similar answers in some, and perhaps many, cases with only subtle differences; current exit value will then provide a clear frame of reference (the view of a market participant) that will be better understood by users.

23. **View B**. Fulfilment provides the most relevant and representationally faithful information about insurance contracts for one or more of the following reasons:

    (a) It would lead to the most decision-useful information for liabilities that are generally not transacted; current exit value uses a hypothetical notion that will not be understood by users easily.

    (b) Even though a transfer notion and a fulfilment notion may come up with similar answers, the fulfilment notion would be more understandable because it would reflect the fact that in most cases the entity itself fulfils the liability with the policyholder over time, rather than transferring it to another market participant that will then be required to fulfil it.

    (c) A transfer notion would ask an insurer to generate market-consistent estimates for a significant number of inputs for which, in effect, little or no observable information is available; particularly expenses and margins.

    (d) The measurement of insurance contracts should be as consistent as possible with the preliminary views on revenue recognition; from the perspective of an allocated transaction price approach (the model proposed in the DP on revenue) it is arguably more natural to think of fulfilment by the entity rather than a market participant.

24. **View C**. A transfer notion could be conceptually preferable for reasons mentioned in paragraph 13. However, a fulfilment notion should be selected for insurance contracts for some of the reasons mentioned in paragraph 14, particularly consistency with the measurement objective for revenue recognition and practical issues with generating market-consistent estimates for liabilities that are generally not transferred.

25. View A results in a transfer based notion (candidate 1). Views B and C result in a fulfilment based notion (candidates 2-4).

26. Staff recommends view C.

27. **Question for the boards**. Do you agree with staff's recommendation in paragraph 26?

How to measure the margin at inception?

28. In paragraph 20 of this paper we summarized the differences in the margins between candidates 1-4. We identified two options for estimating the margin at inception:

    (a) use the premium to estimate the overall margin at inception. In this case the overall margin at inception should equal the expected present value of the premium less cash outflows.

    (b) the premium should not override the estimate of the total margin at inception; this estimate can be done by reference to a margin required by a market participant or by the entity. In this case the total margin at inception does not have to equal the expected present value of the premium less cash outflows.

29. Insurance contracts are typically originated in the retail market (individual contracts) and transferred (if transferred at all, which is not a common event) in the wholesale market. This provides a rationale why at inception the transaction price of an insurance contract **conceptually** does not reflect the price to transfer that contract to a market participant [paragraph 27 of agenda paper 10B provides further background on this].

30. As a consequence, significant day one differences may arise in some, perhaps many, cases if insurance liabilities are measured at **current exit value**. The following views are possible:

(a) a clear rationale exists that the transaction price (premium) does not represent fair value (the current exit value) at inception. Although the premium provides a reasonableness test, it should not override the insurer's estimate. The insurer should therefore recognise the day one difference in profit or loss.

(b) although there is a rationale to explain why the transaction price might not represent fair value at inception, a day one difference should not be recognised in profit or loss because of concerns on reliability and risk of error. The insurer should therefore recognise the day one difference as a separate explicit adjustment within the insurance liability. This approach could be seen as a variation to candidate 1 that includes an additional margin like the one in candidate 3 [paragraph 34 of agenda paper 10B explains this further].

31. The **fulfilment candidates** include three variations; each of those variations treats the margin in a different way. There are broadly two approaches to day one differences under a current fulfilment value:

(a) the overall margin at inception should represent only the cost of bearing risk associated with the remaining obligations. Any resulting day one difference is not part of any liability and will be recognised in profit or loss (candidate 2).

(b) the overall margin at inception should be measured by reference to the premium, a 'positive' day one difference should not be recognised in profit or loss (candidate 3 and 4).

32. Measuring the overall margin at inception by reference to the premium (paragraph 31 (b)) results in an initial measurement that is most consistent with the boards' preliminary view on revenue recognition. Proponents of this approach support it for the following reasons:

(i) Some believe that initially the liability should be measured at the premium because the insurer has not performed under the contract.

(ii) Others think that a day one difference is likely to exist at inception, but would not recognise it in the income statement because of complexity and risk of error.

33. On the measurement objective staff recommended that, as a result of view C, the measurement approach for insurance contracts should be based on a fulfilment notion. Based on the analysis in the previous paragraph, we recommend measuring the overall margin at inception by reference to the premium (paragraph 31(b)). As a result, a positive day one difference will not be recognised in profit or loss.

34. If the boards decide that the measurement objective should be based on an exit notion, we recommend that the insurer does not recognise a positive day one difference in profit or loss for reasons of reliability and risk of error as well as consistency with some service contracts (eg fund management contracts). This day one difference should be recognised as a separate explicit adjustment within the insurance liability; the resulting measurement approach is a variation to candidate 1 that includes an additional margin like the one in candidate 3 (paragraph 30(b)).

35. **Questions for the boards**. Do you agree with staff's recommendations in paragraphs 33 and 34?

Candidates not in the list

36. We considered various other measurement approaches but did not include them in the list of candidates, for reasons discussed below:

    (a) Value in use as defined by IAS 36 *Impairment of assets* (paragraph 37)

    (b) The approach in SFAS 163 *Accounting for Financial Guarantee Insurance Contracts* (paragraph 38)

    (c) Allocated transaction price approach (paragraph 39)

    (d) The measurement approach in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, as updated in the IASB's Liabilities project (paragraph 40)

    (e) The approach in IAS 39 *Financial Instruments: Recognition and Measurement* (paragraph 41)

    (f) Current entry value (paragraph 42)

    (g) Embedded value (paragraph 43)

(h) Expected cash flows, undiscounted and with no risk margins (paragraph 44)

37. Some respondents mentioned value in use as a basis for applying a fulfilment based measurement attribute to insurance contracts because it reflects continuing use and uses entity-specific cash flows, although priced using a market discount rate. The papers for the IASB September 2008 meeting included a table that compared value in use with both an exit notion and a fulfilment notion. We believe that generally a fulfilment notion and value in use are quite similar and both address the concerns respondents have with an exit notion. If we were to define value in use for a liability, we are likely to end up with something quite similar, perhaps identical, to a fulfilment notion. We therefore did not include value in use as a separate candidate. Value in use is a form of entity-specific measurement referred to in FASB Concepts Statements No 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.

38. In May 2008 the FASB issued FASB Statement No. 163. This Statement deals with financial guarantee insurance contracts and uses a hybrid accounting model based on the U.S. GAAP notions of both short- and long-duration insurance contracts as set forth in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.* This model includes some features that depend on particular aspects of financial guarantee insurance contracts. On some features the SFAS 163 model is quite similar to a fulfilment notion. On other features the models differ; for example SFAS 163 has no explicit margin and does not remeasure in all cases. We did not include the SFAS 163 model as a separate candidate.

39. The DP discussed a measurement approach based purely on allocation of the transaction price (customer consideration), as discussed in the project on revenue recognition. The DP took the position that the allocated transaction price model was unlikely to be suitable for insurance liabilities unless it is developed in a way that involves explicit current estimates of the cash flows, the time value of money and explicit margins. The staff believes that position is still appropriate. Agenda paper 10C discusses this in more detail.

40. Another possibility is simply to adopt the measurement approach in IAS 37, as updated by the ultimate outcome of the project to amend IAS 37 (Liabilities project). That approach refers to the amount to transfer the liability (similar to current exit value) or to settle it with the counterparty at the reporting date. The IASB has yet to conclude on the

measurement approach in the Liabilities project, including the role of margins. In practice, that measurement would be estimated by using building blocks similar to those discussed in the DP on insurance contracts (though perhaps not identical in all respects). We therefore did not include the measurement approach from the liabilities project as a separate candidate in the insurance project.

41. We considered whether to adopt the measurement approach(es) in IAS 39. If the boards did this, they would need to consider whether to require measurement at fair value or amortised cost, a choice between these measurements or fair value in specified cases and amortised cost in other specified cases.

    (a) An amortised cost measurement would involve a current estimate of expected cash flows and a locked-in discount rate, covering both the time value of money and the risk margin. We did not include amortised cost in the list of candidates, because applying this model to insurance liabilities would not produce useful information and would involve many complexities and arbitrary features.

    (b) A fair value approach would be similar – and perhaps identical – to current exit value, as described in the DP. Accordingly, we do not present it as a separate candidate.

42. Some measurement approaches that were mentioned in the DP received little support in the comment letters. One of those approaches was current entry value (paragraphs 96-101 of the DP). Selecting this approach would mean measuring the insurance liabilities at current entry price for both initial and subsequent measurement. In the DP the IASB expressed the preliminary view that current exit value was a more relevant measurement approach, particularly because of current entry value's emphasis on the insurer's own pricing methodology for subsequent measurement. Staff therefore believes that current entry value should not be considered any further as candidate for selection.

43. Another approach that received little support was embedded value. Embedded value is an indirect method for measuring insurance liabilities (see paragraphs 105-110 of the DP). Some of the arguments in the DP against embedded value may be solved by the trend towards market-consistent embedded value. Market-consistent embedded value uses many of the same inputs as fulfilment value, and may in practice be close to candidate 2.

Staff therefore believes that this approach should not be considered any further as a candidate for selection.

44. In the DP the Board took the preliminary view that discounting is appropriate for all insurance liabilities, including non-life claims liabilities. Some respondents suggested that, as a consequence of significant differences between life and non-life contracts, the claims liability for non-life contracts should be based on undiscounted claims with no risk margin[6]. However, the DP took the position that discounting could have a material effect for claims liabilities[7]. Furthermore, the DP also takes the position that, in order to convey decision-useful information about the uncertainty associated with future cash flows, insurance liabilities should include a margin. In the light of the arguments mentioned in the DP and arguments made by respondents, staff believes that the DP's position on discounting of claims liabilities is still appropriate.

Next steps

45. Throughout the papers for this meeting we noted issues to be discussed at future meetings. These issues are:

    (a) Use of the unearned premium (candidate 5) in the case of short-duration contracts, either as a reasonable approximation for one of the other candidates or the designated measurement approach in the case of short-duration contracts.

    (b) Guidance on cash flows, including expenses

    (c) Non-performance risk

    (d) Acquisition costs

    (e) Margins and day one differences:

        (i) Guidance on risk margins

[6] Appendix A to this paper includes one of the most detailed descriptions of those differences. The arguments brought forward in the comment letters are consistent with the arguments against discounting mentioned in the DP. Appendix B to this paper reproduces extracts from the DP that give more detail on arguments on discounting and risk margins for non-life claims liabilities, both for and against.

[7] As explained in paragraph 8 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, discounting would not be required when its effect is immaterial.

(ii) Recalibration of margins at subsequent measurement

(iii) Deciding whether the overall margin should be split into a separate risk margin and an additional margin (candidate 3 versus candidate 4)

(f) Liability adequacy test if the margin at inception is calibrated to the premium directly (candidate 4)

(g) Structure of the performance statement

46. Depending on the decisions the boards make at this meetings, some of these issues may become irrelevant.

Appendix A

Extract from the comment letter from the Group of North American Insurance Enterprises

Single Measurement Model for Life and Non-life Insurance Contracts

A fundamental flaw in the DP is that it supports one measurement model for both life and non-life contracts. This is inappropriate in that it ignores the significant, fundamental differences that exist between life and non-life insurance contracts, as summarized below:

- For life contracts, the insured event is generally certain to occur unless the policy lapses whereas for non-life contracts, the insured event may or may not occur.

- For life insurance contracts, the amount of future payment obligation is generally specified, or readily determinable from the contract. For example, whole-life insurance contracts pay an insured upon death (an event certain to occur) and the amount payable at death is specified in the contract. For non-life contracts, the amount of future payment obligation is not specified or readily determinable under the contract (other than in terms of contractual limits). Moreover, in a typical non-life contract, losses, if any, can vary from negligible amounts in excess of deductibles to the contractual limits of the policy.

- For life insurance contracts, the timing of future payments are typically reliably estimable from the contract (e.g., an immediate annuity contract with defined future payments), mortality tables (for annuities with mortality risk), or from a company's own experience (e.g., lapse studies). For non-life contracts, the timing of future payments cannot be reasonably estimated from the contract or by reference to other internal or external data. Stated differently, the uncertainties in a non-life context include not only whether or not a loss may occur during the coverage period (often one year), but also the amount of potential loss, and the fact that losses can be reported several years after the stated coverage period ends and paid years subsequent to the date the loss is reported to the insurer.

Other areas of differentiation include the settlement period between the reporting and payment of claims, which is typically longer for non-life contracts than for life contracts. For example, the period required to determine whether a person has actually died is typically much shorter than the claim settlement period for non-life contracts that often depend on future events. Moreover, while interest is an essential component of pricing and profitability for life products; for non-life contracts, underwriting results are the most critical component of pricing and profitability; and interest, while important, is a secondary consideration.

The following table summarizes these differences:

Key Attributes	**Life**	**Non-life**
Period of coverage	Long, extended duration	Short, fixed duration
Probability of insured event occurring	Generally certain; policyholder will either die or lapse	Unknown, none or many claims
Amount of loss if insured event occurs	Fixed and determinable; face value of policy	Unknown, limited by deductible and policy limit
Timing of loss payments	More predictable; supported by mortality, morbidity and lapse studies	Often unpredictable
Loss settlement period	Typically short	Typically long
Data	More empirical data	Less available predictable data
Uncertainty of estimated ultimate claim payments	Low	Generally very high
Interest income impact on product	Essential	Unrelated to underwriting results / incremental

Given these clear and substantial differences between life and non-life insurance contracts, we believe it is appropriate to develop separate accounting models to conform to their unique economic characteristics.

Appendix B
Arguments for and against discounting non-life claims liabilities
Paragraphs 65 and 66 of the discussion paper

65 Opponents of discounting non-life claims liabilities make the following arguments:

a. Discounting of life insurance liabilities is uncontroversial because life insurance cash flows are relatively predictable. However, that is not the case for many types of non-life insurance. Scheduling estimated payments and determining a discount rate introduces additional subjectivity. This would reduce comparability and permit earnings management. Moreover, scheduling involves additional cost that outweighs possible benefits for users.

b. Some users express concerns that some non-life insurers tend to underestimate their insurance liabilities. Discounting might exacerbate those understatements, depending on how the technique is applied and on the assumptions used.

c. Discounting accelerates recognition of future investment income. This is imprudent and encourages imprudent underwriting practices, such as 'cash flow underwriting' (when pricing assumes that future investment income will offset underwriting losses).

d. Some non-life insurance liabilities generate cash flows that vary with price changes. They are sometimes 'implicitly' discounted by being measured at undiscounted amounts that ignore future inflation. Particularly for short-tail liabilities, this may give a reasonable approximation with less cost and complexity than explicit discounting.

e. If claims liabilities are undiscounted and do not include risk margins, that is an implicit assumption that discounting and risk margins tend, in practice, to offset each other.

f. Users rely on disclosure of prior year loss development to understand and test the risks and uncertainties inherent in estimates of cash flows and the effect of changes in those estimates. This may become more difficult if the

measurement introduces more variables (for the time value of money and for risk margins).

g. Using a current discount rate will increase the volatility of the amounts reported in the balance sheet and income statement. This may make it more difficult for users to understand an insurer's performance.

h. It is confusing to report interest expense on a liability that does not bear interest

i. It would be preferable to confine discounted measurements to supplementary disclosures until users and preparers become more familiar with them. Some analysts prefer to eliminate the effect of discounting from claims liabilities. This may be partly so that they can make comparisons with insurers in those countries where most claims liabilities are undiscounted and partly because they believe that the undiscounted amounts may be underestimated and prefer those amounts not to be reduced by discounting.

66 However, for the following reasons, the Board's preliminary view is that discounting should be used for all insurance liabilities:

a. Although discounting may cause some increase in both subjectivity and cost, the increase in relevance outweighs these concerns, for the following reasons:

i. Insurers and investors are not indifferent to the timing of cash flows. An amount payable tomorrow is not equivalent to the same amount payable in ten years. If a balance sheet measures those obligations at the same amount, it does not represent faithfully the insurer's financial position and is less relevant to users.

ii. Undiscounted measurements create opportunities for transactions (for example, some financial reinsurance transactions) that exploit divergences between the accounting representation of the liabilities and their economic substance.

iii. IFRSs already require discounting for all other comparable items, such as long-term provisions, employee benefit obligations and finance leases. Extending discounting to all insurance liabilities will make financial statements more internally consistent, and hence more relevant and reliable.

iv. Discount rates and the amount and timing of future cash flows can generally be estimated in practice in a sufficiently reliable and objective way at a reasonable cost. Absolute precision is unattainable, but it is also unnecessary. Discounting can be applied in a way that leads to answers within a reasonably narrow range and results in more relevant information for users. Indeed, many entities already have experience of discounting, both to support investment decisions and to measure items for which IFRSs already require discounting.

v. In some cases, discounted measurements may be more reliable, and less subjective, than undiscounted measurements. When measurements include the effect of inflation explicitly or implicitly, insurers already need to schedule payments. The effect of the time value of money tends to offset much of the effect of inflation, and variations in estimates of cash flows far in the future are smaller when reduced to their present values.

b. If it is true that some insurers underestimate claims liabilities, the appropriate response is to improve the methods used to make those estimates, not to compensate for those underestimates by excluding an economically relevant factor from the measurement. If, as some assert, some insurers are unwilling or unable to make measurements that represent faithfully what those measurements purport to represent, that is no reason to adopt a less relevant measurement objective.

c. Discounting does not accelerate the recognition of investment income. Rather, it represents faithfully the economic fact that money has a time value.

d. Implicit discounting makes the unrealistic assumption that two different variables (claim inflation and time value) will more or less offset each other in every case. Requiring explicit estimates of these effects will improve financial reporting. Moreover, experience has shown that making explicit estimates improves entities' ability to make unbiased estimates of cash flows.

e. Measurements that consider the time value of money and risk margins separately and explicitly will be more relevant to users and more reliable than measurements that assume, with no testing, that these two factors cancel each other out in all cases.

f. Inclusion of discounted measurements in the balance sheet does not preclude disclosures about undiscounted loss development if that disclosure is helpful to users.

g. Discounting is consistent with rational pricing decisions, which typically reflect the time value of money and the risk inherent in the contract. Therefore, any volatility resulting from discounting is a faithful representation of an insurer's activity.

h. Although claim liabilities do not bear explicit interest, interest is implicit in the pricing of insurance contracts.

i. Appropriate recognition and measurement provide a structured aggregation of financial information. Disclosure can provide valuable supporting information, but is not an adequate substitute.

j. Some countries have introduced discounting and risk margins and would consider it a backward step to remove them.