June 2013

Basis for Conclusions
Exposure Draft ED/2013/7
A revision of ED/2010/8 *Insurance Contracts*

Insurance Contracts

Comments to be received by 25 October 2013

IFRS®

Basis for Conclusions on Exposure Draft Insurance Contracts

Comments to be received by 25 October 2013

This Basis for Conclusions accompanies the Exposure Draft ED/2013/7 *Insurance Contracts* (issued June 2013; see separate booklet). The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by **25 October 2013** and should be submitted in writing to the address below or electronically via our website www.ifrs.org using the 'Comment on a proposal' page.

All responses will be put on the public record and posted on our website unless the respondent requests confidentiality. Requests for confidentiality will not normally be granted unless supported by good reason, such as commercial confidence.

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Introduction

BC1 The International Accounting Standards Board (the IASB) developed this Exposure Draft *Insurance Contracts* ('this Exposure Draft') after considering the responses to the proposals in its 2010 Exposure Draft *Insurance Contracts* (the '2010 Exposure Draft') and its 2007 Discussion Paper *Preliminary Views on Insurance Contracts* (the '2007 Discussion Paper'). After reviewing the responses to this Exposure Draft, the IASB expects to issue a Standard on insurance contracts that will replace IFRS 4 *Insurance Contracts*.

BC2 This Basis for Conclusions focuses on the IASB's considerations in reaching the conclusions on the targeted range of issues for which it is now seeking input. Individual IASB members gave greater weight to some factors than to others. In particular, some IASB members, while disagreeing with some specific proposals, nonetheless approved this Exposure Draft for publication because they believe that the benefits of finalising a Standard on insurance contracts outweighed their concerns about any individual aspects of the proposals.

BC3 The IASB has provided a complete draft of the proposed Standard so that interested parties can consider the IASB's targeted proposals within the context of the proposed Standard. Appendix A to this Basis for Conclusions summarises the IASB's reasons for its conclusions on issues for which it is no longer seeking input.

Background

The need for a Standard for insurance contracts

BC4 Standards that apply to other types of contracts are difficult to apply to many types of insurance contracts because:

(a) interdependencies between rights and obligations can make it difficult to separate the multiple performance obligations provided by the contract, or to allocate the consideration paid by policyholders to those individual performance obligations.

(b) long durations can mean that estimates made at the inception of a contract to measure obligations do not provide useful information throughout the duration of the contract.

(c) a lack of observable data can make it difficult for users of financial statements to assess whether estimates are reasonable or accurate.

(d) uncertainty of outcomes can make it difficult to estimate the amount of the entity's obligations. Furthermore, options and guarantees embedded in insurance contracts can cause significant changes in the estimates of the cash flows needed to fulfil the contracts and make the ultimate profit or loss more uncertain. Examples of such embedded options and guarantees include:

(i) guarantees of minimum investment returns, minimum interest rates, minimum crediting rates, minimum annuity rates or guarantees of maximum charges for mortality;

(ii) surrender options, conversion options or options to cease or suspend payment; and

(iii) options for the policyholder to reduce or extend coverage or to buy additional coverage.

BC5 As a result, existing practice has tried to address the problems of applying other Standards to account for insurance contracts in a piecemeal fashion over many years. However, the outcome of some or all existing accounting models may not provide useful financial information because:

(a) they do not provide relevant information about the measurement of insurance contract liabilities because they use assumptions that are made at the beginning of the contract that are not updated to provide timely information and that omit relevant information about the time value of money.

(b) they do not provide relevant information about embedded options and guarantees, for example:

(i) by ignoring the time value of some or all embedded options and guarantees. The time value of such an item is the value arising from the possibility that the option or guarantee may be in the money at the time when it is exercisable.

(ii) by ignoring the intrinsic value of some or all embedded options or guarantees. The intrinsic value of such an item reflects the extent to which the option or guarantee is in the money at the measurement date, and reflects the difference between the current value of the variable underlying the option or guarantee and the value specified in the underlying option or guarantee.

(iii) by capturing the intrinsic value of some or all embedded options or guarantees on a basis that reflects management's expectations but that is inconsistent with current market prices.

(c) they do not provide comparable information about insurance contracts, because they use a variety of accounting models for different types of contracts. As a result, it may be unclear which model applies to more complex contracts (such as multi-line or stop-loss contracts) and it may be difficult to resolve emerging issues for new types of insurance contracts.

BC6 Furthermore, many existing practices may not meet the objectives of general purpose financial statements because:

(a) accounting methods have sometimes been tailored to meeting the reporting requirements of local insurance regulators rather than to meeting the sometimes different requirements of investors and other capital providers; and

(b) some accounting practices used by entities that issue insurance contracts differ from those used by other entities, such as banks and fund managers, for economically similar transactions. These differences impede comparisons between entities that issue insurance contracts and

other financial institutions that compete for investor capital. These differences can also mean that financial conglomerates produce financial statements that are internally inconsistent.

BC7 The IASB believes that the lack of a comprehensive Standard for insurance contracts means that financial statements do not provide users with information that is relevant and that faithfully represents the economics of insurance contracts. Accordingly, the IASB's project on insurance contracts is intended to address these problems by:

(a) reducing inconsistencies and weaknesses in existing practices, for example by:

(i) reporting the intrinsic and time value of options and guarantees; and

(ii) limiting arbitrariness created by the separation of performance obligations within a single insurance contract by treating an insurance contract as a bundle of rights and obligations that generate a package of cash inflows and cash outflows;

(b) measuring insurance contracts in a way that reflects current assumptions about cash flows, the time value of money and the entity's perception of the effect of risk; and

(c) improving comparability across entities, jurisdictions and capital markets; and

(d) developing a coherent framework for all types of insurance contracts so that the complexity that arises from the many overlapping accounting models that have been developed in the past is eliminated.

The IASB's project on insurance contracts

BC8 The IASB's predecessor organisation, the International Accounting Standards Committee, began a project on insurance contracts in 1997. The IASB was constituted in 2001 and included that project in its initial work plan. Because it was not feasible to complete the project in time for the many entities that would adopt IFRS in 2005, the IASB split the project into two phases.

Phase I: limited improvements provided by IFRS 4

BC9 The IASB completed Phase I in 2004 by issuing IFRS 4, which:

(a) made limited improvements to accounting practices for insurance contracts; and

(b) required an entity to disclose information about insurance contracts.

BC10 However, the IASB has always intended to replace IFRS 4 as soon as possible because it permits a wide range of practices. In particular, IFRS 4 includes a 'temporary exemption' that explicitly states that an entity does not need to ensure that its accounting policies are relevant to the economic decision making needs of users of financial statements or that such accounting policies are reliable. As a result, there is diversity in the financial reporting of insurance contracts across entities applying IFRS.

Phase II: a comprehensive Standard for insurance contracts

BC11 This Exposure Draft is part of the second phase of the IASB's project. It proposes a comprehensive Standard for insurance contracts. This Exposure Draft further develops the proposals set out in the following consultation documents previously issued by the IASB:

(a) the 2007 Discussion Paper, which set out the IASB's preliminary views on the main components of an accounting model for an entity's rights and obligations (assets and liabilities) arising from an insurance contract. The IASB received 162 comment letters in response.

(b) the 2010 Exposure Draft, which contained proposals for a Standard on insurance contracts. The IASB received 251 comment letters in response.

BC12 When developing the proposals in this Exposure Draft, the IASB undertook extensive consultation over many years. In addition to the 2007 Discussion Paper and the 2010 Exposure Draft, the proposals in this Exposure Draft have been developed after considering:

(a) input from the Insurance Working Group, a group of senior financial executives of insurers, analysts, actuaries, auditors and regulators that was established in 2004;

(b) field tests conducted in 2009 and 2011, which helped the IASB to better understand some of the practical challenges of applying the proposed insurance model; and

(c) over 400 meetings with individuals and groups of users of financial statements, preparers, actuaries, auditors, regulators and others in order to test proposals and to understand concerns raised on the 2010 Exposure Draft by affected parties.

BC13 This Exposure Draft confirms the approach proposed in the 2007 Discussion Paper and the 2010 Exposure Draft that an entity should measure an insurance contract in a way that portrays a current assessment of the amount, timing and uncertainty of the future cash flows that the entity expects the contract to generate as it is fulfilled, adjusted for risk and for the time value of money. In the IASB's view, that approach would provide relevant information about the amount, timing and uncertainty of future cash flows that will arise as the entity fulfils its existing insurance contracts. Such information includes:

(a) explicit estimates of cash flows. Explicit estimates increase the entity's understanding of the risks and reduce the possibility that entities will overlook changes in circumstances.

(b) information about the entity's perception of risk through the inclusion of an explicit risk adjustment. Accepting and managing risk are the essence of insurance.

(c) information about the time value and intrinsic value of all options and guarantees embedded in insurance contracts, including information about the economic mismatches that occur when insurance liabilities and related assets respond differently to the same changes in economic conditions. For example, such economic mismatches arise when:

(i) the duration of the insurance contract liability differs from the duration of fixed interest assets backing those liabilities;

(ii) the contract provides any guarantees written by the entity, for example, a requirement that the entity will pay policyholders the higher of a return based on actual asset returns and a specified minimum return;

(iii) the amounts payable to policyholders is not affected by changes in the risk of non-performance relating to that the entity holds; and

(iv) the liquidity of the assets that the entity invests in differs from the liquidity that is provided to policyholders.

(d) consistency with observable current market prices for financial market variables, such as interest rates and equity prices where available. Such prices provide a more understandable and credible benchmark for users of financial statements, even though market prices are not available to support all the inputs used when measuring insurance contract liabilities.

(e) a reduction in the accounting mismatches in the statement of financial position that would arise if changes in economic conditions affect insurance contracts and the related underlying items equally but those items are measured differently.

BC14 The proposed measurement model was generally supported by the respondents to the 2010 Exposure Draft and the IASB has confirmed them in this Exposure Draft. However, the IASB proposes four significant changes to refine the measurement and presentation proposals in the 2010 Exposure Draft. The IASB is now proposing that:

(a) the contractual service margin should be adjusted to reflect the changes in the estimates of cash flows relating to future coverage or services (see paragraphs BC26–BC41).

(b) if a contract requires an entity to hold underlying items and specifies a link to returns on those underlying items, the entity should measure and present fulfilment cash flows that are expected to vary directly with returns on those underlying items on the same basis that is used to measure and present the underlying items (see paragraphs BC42–BC71).

(c) entities should present insurance contract revenue in profit or loss as they satisfy their obligations under the contract to provide coverage or other services (see paragraphs BC73–BC116). Insurance contract revenue excludes investment components, defined as amounts that the insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

(d) entities should recognise in profit or loss interest expense based on the time value of money that the entity determined at contract inception. An entity would recognise in other comprehensive income the difference between discounting the expected cash flows using the discount rate

that reflects the current view of the time value of money and the time value of money that the entity expected at contract inception (see paragraphs BC117–BC159).

BC15 In addition, the IASB has reconsidered the trade-off between verifiability and comparability for contracts that will be in force at the date of transition and those that will be issued after the date of transition. Accordingly, the IASB has modified its proposals so that entities would measure retrospectively all insurance contracts that exist at the date of transition if practicable. If retrospective application is impracticable, entities would measure insurance contracts using an estimate of the remaining contractual service margin that uses all of the available objective data (see paragraphs BC160–BC191).

Reasons for this Exposure Draft

BC16 Because this Exposure Draft benefits from previous consultations, the IASB has decided to focus this consultation on the significant changes to the proposals that the IASB made since the 2010 Exposure Draft. In particular, the IASB seeks input on whether unintended consequences will arise from those areas and input that will help it to assess the costs and benefits of the proposals as a whole.

BC17 The changes that the IASB has made largely respond to the comment letters on the 2010 Exposure Draft. In the IASB's views, its proposals would provide a better depiction of the effect of insurance contracts on an entity's financial position and performance than the proposals in the 2010 Exposure Draft. However, the IASB notes that the uncertainty inherent in insurance contracts inevitably results in complex accounting that depends heavily on assumptions, even for relatively simple insurance contracts. Moreover, many insurance contracts are complex. Reflecting this inherent complexity means that financial reporting by entities that issue insurance contracts is often complex and may be achieved only at significant costs for both users and preparers of financial statements.

BC18 Accordingly, the IASB seeks to understand whether the revisions to its proposals create extra complexity for users of financial statements and to gain insight into the drivers of the operational costs for preparers of financial statements. This will assist the IASB to assess whether the costs of implementing its revised proposals exceed the costs of implementing the 2010 Exposure Draft, and whether the resulting additional benefits would justify the cost.

BC19 The IASB believes that it already has sufficient information to finalise its conclusions on the areas that it has not targeted in this Exposure Draft. In particular, between July 2010 and January 2013, the IASB has:

(a) largely confirmed the core principles in the 2010 Exposure Draft. The changes to the 2010 Exposure Draft mostly clarified or simplified the application of those principles. In some cases the changes have resulted in accounting that is more consistent with existing requirements and practices.

(b) made extensive efforts to consult interested parties and to assess whether there are unintended consequences of its proposals. The IASB plans to continue this process during the re-exposure period. It also plans to undertake an additional round of fieldwork.

(c) supplemented the IASB's due process by:

(i) making reports of the IASB's tentative decisions in some areas publicly available.

(ii) providing extracts of working drafts that show how these decisions would be implemented.

BC20 As a result, the IASB does not intend to revisit the arguments that it has previously rejected or the consequences that it has previously considered when it assesses the issues raised in the comment letters on this Exposure Draft. Nevertheless, the IASB recognises that respondents will wish to assess the IASB's proposals in the areas now targeted for comment within the context of the proposed Standard. Accordingly, this Exposure Draft presents the whole of the proposed Standard for insurance contracts and the IASB seeks input on the clarity of the drafting and the effects of the proposals as a whole. Appendix A sets out the basis for the IASB's conclusions on areas it does not intend to re-examine.

Role of the FASB in the development of this Exposure Draft

BC21 Since 2008, most of the IASB's deliberations on the insurance contracts model have been conducted jointly with the US standard setter, the Financial Accounting Standards Board (the FASB). The FASB's objectives in participating in the project jointly with the IASB were to improve and simplify US Generally Accepted Accounting Principles (US GAAP) and enhance convergence of the financial reporting requirements for insurance contracts and to provide investors with useful information. Some specific potential improvements to US GAAP had been noted by the FASB in its Discussion Paper *Preliminary Views on Insurance Contracts*, published in September 2010, and are described in paragraph BCA20.

BC22 The IASB and FASB are publishing separate Exposure Drafts. This is because this is the IASB's second Exposure Draft and the IASB is seeking input only on significant changes to its previous proposals. In contrast, the FASB is seeking input on the entire package of its proposed improvements to US GAAP because the FASB has not previously sought public comment on its detailed proposals.

BC23 The IASB's decision to seek input on specific areas reflects the IASB's need to balance the desire to work towards a Standard that is or will be converged with US GAAP, with the urgent need to finalise a Standard on insurance contracts. Because IFRS 4 permits a wide range of practices to continue, the IASB believes that its proposals will significantly improve comparability and consistency in the accounting for insurance contracts in accordance with IFRS, regardless of whether that Standard is fully or partially converged with US GAAP.

BC24 Appendix D to this Basis for Conclusions describes in more detail the FASB's involvement in the project, including where the IASB and FASB have reached

common conclusions on their proposals for the accounting for insurance contracts and where some differences remain. In addition, this Basis for Conclusions discusses the reasons for any differences between the IASB and FASB that relate to the specific areas that the IASB has targeted for input.

Significant changes to the measurement model since the 2010 Exposure Draft

BC25 This section discusses the following measurement issues on which the IASB seeks input:

(a) adjusting the contractual service margin for some changes in the estimates of cash flows (see paragraphs BC26–BC41); and

(b) measuring contracts with cash flows that depend on underlying items (see paragraphs BC42–BC71).

Other issues relating to the measurement of insurance contracts are discussed in paragraphs BCA22–BCA150 of Appendix A. Specifically, paragraphs BCA71–BCA73 and BCA105–BCA115 discuss other issues related to the contractual service margin and paragraphs BCA58–BCA63 discuss other issues related to contracts with cash flows that depend on underlying items. The IASB is not seeking input on those other issues.

Adjusting the contractual service margin (paragraphs 30(c)–(d) and B68)

Background and rationale

BC26 The main service provided by insurance contracts is insurance coverage, but contracts may also provide asset management or other services. An entity that provides services will typically require a payment of more than the risk-adjusted expected present value of the expected cost for providing the services. Thus, the measurement of an insurance contract at inception includes a contractual service margin, which represents the margin that the entity has charged for the services it provides in addition to bearing risk. The expected margin charged for bearing risk is represented by the risk adjustment (see paragraphs BCA89–BCA104).

BC27 This Exposure Draft confirms the proposal in the 2010 Exposure Draft that the contractual service margin should be measured, at initial recognition of the contract, as the difference between the expected present value of cash inflows less the expected present value of cash outflows, after adjusting for uncertainty and any cash flows received or paid before initial recognition. Unlike the 2010 Exposure Draft, this Exposure Draft proposes that an entity should update the measurement of the contractual service margin for changes in expected cash flows relating to future coverage or other future services.

BC28 The 2010 Exposure Draft proposed that the contractual service margin that is recognised at contract inception should not be adjusted subsequently to reflect the effects of changes in the estimates of the fulfilment cash flows. The reasons underlying that view were that:

(a) changes in estimates during an accounting period are economic changes in the cost of fulfilling a portfolio of contracts in that period, even when they relate to future services. Recognising changes in estimates immediately in profit or loss would provide transparent, relevant information about changes in circumstances for insurance contracts.

(b) some believe that the contractual service margin represents an obligation to provide services that is separate from the obligation to make the payments required to fulfil the contract. Changes in the estimates of the payments that are required to fulfil the contract do not increase or decrease the obligation to provide services and consequently do not adjust the measurement of that obligation.

(c) for changes in the estimates of financial market variables, such as discount rates and equity prices, there would be accounting mismatches if the assets that back insurance liabilities were measured at fair value and the contractual service margin were adjusted for those changes.

BC29 Those reasons remain persuasive to the FASB. In particular, the FASB believes that more transparent, relevant information about changes in circumstances is provided to users of financial statements when changes in estimates of fulfilment cash flows are recognised immediately in profit or loss rather than offset by adjustments to the margin. Accordingly, the margin in the FASB's proposals (which incorporates implicitly in the margin established at contract inception both the contractual service margin and the risk adjustment) would not be adjusted to reflect changes in the estimates of the fulfilment cash flows.

BC30 In the responses to the IASB's 2010 Exposure Draft, many stated that the measurement of the insurance contract liability would not provide a faithful representation of the unearned profit that would be recognised over the remaining coverage period if the margin was not adjusted to reflect changes in estimates made after inception. Those with this view argued that it would be inconsistent to prohibit the recognition of gains at initial recognition, but then to require the subsequent recognition of gains on the basis of changes in estimates made immediately after initial recognition.

BC31 The IASB was persuaded by this view. As a result, this Exposure Draft proposes that differences between current and previous estimates of cash flows relating to future coverage or other future services would not be recognised in profit or loss immediately. Instead, they would be added to, or deducted from, the contractual service margin, and thereby recognised in profit or loss in future periods. The IASB's reasons are as follows:

(a) changes in estimates of cash flows relating to future coverage or other future services affect the future profitability of the contract. Thus, adjusting the contractual service margin to reflect these differences would provide a more faithful representation of the remaining unearned profit in the contract after inception.

(b) immediate recognition of adverse changes in estimates can make contracts that are profitable overall appear to be loss-making in some years. Conversely, it can also make contracts that become loss-making overall appear to be profitable in later years. Adjusting the contractual

service margin to reflect changes in estimates of cash flows relating to future coverage and other future services would avoid these counter-intuitive effects.

(c) adjusting the contractual service margin to reflect changes in estimates relating to future coverage or other future services would increase consistency between measurement at inception and subsequent measurement.

(d) adjusting the contractual service margin for changes in estimates would make more transparent the effects of those changes in estimates because users of financial statements tend to place more weight on recurring changes in estimates than on one-time changes in estimates. Thus changes in estimates would be highlighted if they are recognised as part of the profit that the entity recognises in future periods, rather than all changes in estimates being recognised in the period in which they occur.

BC32 Consistently with its view of the contractual service margin as the profit that is recognised as the entity provides coverage and other services, the IASB proposes that:

(a) the contractual service margin would be increased as a result of favourable changes. There should not be a limit on the amount by which the contractual service margin could be increased. This is because favourable changes in estimates, whether lower than expected cash outflows or higher than expected cash inflows, increase the profit that the entity will recognise from the contract up to a maximum that is set by the amount of total expected cash inflows from the contract.

(b) the contractual service margin cannot be negative for insurance contracts that the entity issues. This means that once the contractual service margin has been exhausted, overall losses arising from the contract would be recognised immediately in profit or loss. This is because any excess of fulfilment cash flows over the contractual service margin would mean that the contract is expected to be onerous (ie loss-making), rather than profit-making, in the future. Such losses are recognised as an increase in the liability and corresponding expense in the period.

(c) only differences in estimates of cash flows relating to future coverage or other future services would result in an adjustment in the contractual service margin. Accordingly:

(i) the contractual service margin would not be adjusted for changes in estimates of incurred claims because these claims relate to past coverage. Such changes would be recognised immediately in profit or loss.

(ii) the contractual service margin would be adjusted for differences between expected and actual cash flows if those differences relate to future coverage; for example, if they relate to premiums received for future coverage. The entity would adjust the margin for both the change in premiums and any resulting changes in future cash outflows.

(iii) a delay or acceleration of repayments of investment components would adjust the contractual service margin only if future services are affected.

(iv) because changes attributable to gains or losses on underlying items do not relate to unearned profit from future services from the insurance contract, they would be recognised immediately in comprehensive income.

(d) adjustments to the contractual service margin are recognised prospectively using the latest estimates of the future cash flows. In other words, any changes would be recognised in profit or loss as the contractual service margin is recognised over the coverage period that remains after the adjustments are made.

(e) the effects of changes in discount rates and in the risk adjustment do not affect the amount of unearned profit because those changes unwind over time. Accordingly, the contractual service margin would not be adjusted to reflect the effects of changes in the discount rate or in the risk adjustment.

Consequences

Consistency with revenue recognition principles

BC33 When an entity adjusts the contractual service margin for changes in estimates of cash flows relating to future coverage or other future services, there is a transfer between the components of the insurance contract liability, with no change in the total carrying amount of the liability. The total insurance contract liability is remeasured for changes in estimates of expected cash flows only if there is an unfavourable change relating to future coverage or other future services that exceeds the remaining balance of the contractual service margin, ie if the contract has become onerous. This means that the effect of offsetting changes in estimates against the contractual service margin is that the measurement of those liabilities as a whole does not change as a result of changes in expected claims and expenses that would lower expected profit. That is consistent with the measurement of contract liabilities under the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*[1], which also does not remeasure performance obligations based on changes in cash outflows.

BC34 The IASB's 2007 Discussion Paper proposed an explicit service margin that was remeasured. However, those proposals differed from the proposals in this Exposure Draft and the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*. The 2007 Discussion Paper proposed that the service margin would be measured as the estimated margin that market participants would require and that it would be remeasured every period. In contrast, the contractual service margin in this Exposure Draft is a contractual margin

1 This Basis for Conclusions discusses the relationship between the proposals in this Exposure Draft and the 2011 Exposure Draft *Revenue from Contracts with Customers*. The IASB expects to finalise a Standard arising from that Exposure Draft during 2013. During redeliberations, the IASB has made significant changes to some of the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*. The IASB plans to consider the effect of those changes on the proposals in this Exposure Draft in due course.

implied by the premiums that the entity charged. That contractual service margin is the margin that produces no profit or loss at inception and is remeasured only for changes in estimates of cash flows relating to future coverage or other future services. Accordingly, the contractual service margin proposed in this Exposure Draft reflects the price that the entity charged to provide the remaining services. As a result, the measurement of the liability is consistent with the measurement of contract positions applying the 2011 Exposure Draft *Revenue from Contracts with Customers*, which also reflects the price that the entity charged to provide services.

Complexity

BC35 As a result of the proposals to adjust the contractual service margin by changes in estimates relating to future coverage or other future services, there is an increase in complexity for both users and preparers of financial statements. For users of financial statements, complexity may rise from the need to understand how gains and losses arising from events of previous years affected current-year profit or loss. For preparers, complexity would arise from the need to identify separately the cash flows that would adjust the contractual service margin and those that would be recognised immediately in the statement of profit or loss and other comprehensive income. For both, a particular source of complexity arises from the distinction between changes in estimates relating to future coverage or other future services and experience adjustments relating to past coverage. That distinction may be subjective and vary according to when the entity makes the change in estimate. This is because a change in cash flows would be recognised as an adjustment to the contractual service margin if the entity changes its estimate of the cash flow before that cash flow occurred, but it would be recognised in profit or loss if the entity did not change its estimate and instead recognised an experience adjustment when the cash flow occurred.

Other approaches considered but rejected

Adjusting the contractual service margin for changes in the risk adjustment

BC36 The IASB proposes that all changes in the risk adjustment should be recognised immediately in profit or loss. In other words, the contractual service margin would not be adjusted for changes in the risk adjustment. However, changes in the risk adjustment contain three components: a release from risk as the coverage period expires, changes in risk that relate to future coverage periods and changes in risk that relate to incurred claims. Some argue that if the contractual service margin represents the unearned profit in the contract, it should be adjusted to reflect changes in the estimates of the risk associated with future coverage.

BC37 However, in the IASB's view:

(a) most changes in the risk adjustment would relate to the expiry of coverage. The change in risk adjustment relating to the expiry of coverage is the profit recognised from bearing risk in that period of coverage. Accordingly, such changes should be recognised in profit or loss.

(b) changes in risk relating to future coverage periods or changes in risk relating to incurred claims would arise when there are unexpected changes in circumstances. Changes in estimates of risks assumed in an insurance contract are critical to the measurement of the performance of commitments that are already underwritten. Recognising in profit or loss such changes in risk would provide more transparent information about those changes in circumstances.

(c) it would be difficult to disaggregate the overall change in risk in each period into:

(i) the expiry of risk as coverage is provided; and

(ii) the changes in estimates of risk associated with future coverage or incurred claims.

(d) changes in risk do not affect the amount of unearned profit relating to future coverage or services because they unwind over time.

Adjusting the contractual service margin by changes in the carrying amount of underlying items

BC38 When the contract requires the entity to hold underlying items and specifies that the amounts paid to policyholders vary with returns on those underlying items, the entity recognises profit from the net cash flows arising from the contract and from the entity's share of the any returns on underlying items that the entity holds. Accordingly, some respondents suggested that, when the contract requires the amounts paid to policyholders to vary with returns on underlying items, the contractual service margin should be adjusted so that it represents the whole of the unearned profit arising from both the insurance contract and the underlying items. This would mean that the contractual service margin would be adjusted to reflect those changes in the expected returns on underlying items that the entity does not expect to pay to, or recover from, the policyholder.

BC39 Those supporting this view further note that adjusting the contractual service margin as described in paragraph BC38 would be consistent with:

(a) the IASB's reasons for adjusting the contractual service margin for changes in estimates relating to future services—that the gain or loss will be recognised as the coverage or services are provided. Proponents of this view believe that adjusting the contractual service margin for changes in expected returns on underlying items would ensure that the contractual service margin would represent the current unearned profit in the portfolio of contracts, including the underlying items. They also believe that both gains and losses arising from the amount charged to the policyholder, and all gains and losses arising from changes in the value of underlying items, including the portion that will not be paid to policyholders, should be treated consistently. This is because both types of gains and losses provide profit that is recognised from a portfolio of insurance contracts when the contract specifies that the payment to policyholders depends on underlying items.

(b) adjusting the contractual service margin to reflect the time value of money through accretion of interest. In both cases, the contractual service margin is adjusted to reflect the change in value that occurs when the premium is received before the related services are provided.

BC40 However, the IASB was not persuaded by these arguments because:

(a) although many entities manage assets and liabilities as part of an overall portfolio, a fundamental principle underlying IFRS is that assets and liabilities should be accounted for separately and that the accounting for assets and liabilities should be consistent with the respective characteristics of those assets and liabilities. Separate reporting of assets and liabilities is necessary to ensure that financial statements continue to depict, on an ongoing basis, the success or failure of the entity's asset-liability management practices. Consistent with that principle, when the characteristics of a liability reflect a dependence on assets (for example, because of an obligation to make payments based on the returns on assets), the measurement of the liability reflects that dependence. It would be inconsistent with this principle to modify the accounting for changes in the value of assets if that value is not expected to vary as a result of changes in the liability. Instead, those assets, and the gains and losses arising from those assets, should be accounted for in accordance with other applicable Standards, for example IFRS 9 *Financial Instruments*.

(b) the IASB does not agree that reflecting the price that the entity would have charged for a contract that provides the same returns on the existing pool of underlying items is consistent with the principle underlying the accretion of interest. Accretion of interest adjusts the contractual service margin to reflect the time value that arises when an entity receives a premium in advance of performing a service. In contrast, adjusting the contractual service margin to reflect the difference between what an entity originally expected to make on its own account and what it actually makes from investing the premium that was received in advance includes more than only time value. It also reflects the economic decisions that the entity made about the assets it chooses to hold.

BC41 Accordingly, this Exposure Draft does not propose adjusting the contractual service margin by changes in estimates relating to the returns from assets backing insurance contracts.

Cash flows that are expected to vary directly with returns on underlying items (paragraphs 25–26(a), 33–34, 60(h), 64, 66 and B83–B87)

BC42 Some cash flows of some insurance contracts are expected to vary with returns on underlying items. Underlying items may be assets, groups of assets and liabilities, or the performance of a fund or an entity. The cash flows may be expected to vary with returns on underlying items either at the entity's discretion or because the contract specifies a link between the amounts paid to the policyholders and the returns on underlying items.

BC43 In some cases, the contract specifies that the issuer must hold the underlying items directly (for example, in some unit-linked contracts). In other cases, although the entity may choose to hold the underlying items to reduce its own risk exposure, the contract does not require the issuer to hold the assets on which the payment to the policyholder is based. An example is an index-linked contract in which the policyholder participates in the market value of items as observed in markets or other external indexes. The issuer may or may not choose to hold the underlying assets.

BC44 The proposals in this Exposure Draft would account for the cash flows that are expected to vary directly with returns on underlying items as follows:

(a) paragraph 25 proposes that an entity should apply a discount rate to the expected cash flows of an insurance contract that reflects the characteristics of those cash flows. It follows that, to the extent that cash flows are expected to vary with returns on underlying items, the characteristics of the liability include that dependence, and the rate used to discount those cash flows should also therefore reflect that dependence. This is the case regardless of whether the relationship between the cash flows of the contract and the underlying items is specified by the contract or whether the relationship arises because the entity has discretion over the amount and timing of payments in any given period but expects to pass on returns on underlying items. The discount rate is discussed in paragraphs BCA64-BCA88.

(b) paragraphs 33–34 and 66 propose that, when the contract requires the entity to hold underlying items and specifies a link to returns on those underlying items, the measurement and presentation mismatches that are purely accounting mismatches would be eliminated. This would be an exception to the general requirements of this Exposure Draft. For such contracts, the entity would be required to recognise the changes in the value of any embedded options in profit or loss. These proposals are discussed in paragraphs BC45–BC71.

(c) paragraph 60(h) proposes that the interest expense recognised in profit or loss is measured using the discount rate that reflects the characteristics of the liability that is measured at initial recognition, and that discount rate is updated if there are changes in payments to policyholders that arise from changes in underlying items. This proposal is discussed in paragraphs BC117–BC159.

Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (paragraphs 33–34, 66 and B83–B87)

BC45 'Economic mismatches' arise if the value of, or cash flows from, related assets and liabilities respond differently to changes in economic conditions. 'Accounting mismatches' arise if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts and presentation of those assets and liabilities do not reflect those economic changes equally because different measurement or presentation methods are applied.

BC46 There is no economic mismatch between the returns on underlying items and the portion of the insurance contract liability that varies directly with those returns if the contract requires both the following conditions:

(a) the entity is required to hold the underlying items; and

(b) the cash flows to policyholders are required to vary directly with returns on those underlying items.

BC47 When those conditions are met, the IASB proposes to eliminate any accounting mismatches in measurement and presentation by requiring entities to measure those fulfilment cash flows at an amount equal to the related part of the carrying amount of the underlying items. Because there is no possibility of economic mismatches, any mismatches would be accounting mismatches. The IASB's proposal would depict that the entity will fulfil that part of its obligation by, in effect, delivering the cash flows arising from part of the underlying items to policyholders.

BC48 This proposal builds on the proposals in the 2010 Exposure Draft to measure the insurance contract on the basis of all the expected cash flows that will arise as the entity fulfils the insurance contract. As a result, the measurement of the insurance contract would be consistent with the fair value of the underlying items. This meant that the proposals in the 2010 Exposure Draft would have substantially eliminated accounting mismatches in measurement and presentation between the cash flows arising from the insurance contract and underlying items measured at fair value through profit or loss. By measuring the insurance contract liability at current value, it depicted that the entity would fulfil its obligation by delivering cash flows arising from underlying items measured at fair value.

BC49 The 2010 Exposure Draft further proposed to eliminate some particular accounting mismatches by proposing that the entity's own shares and owner-occupied property should be recognised and measured at fair value for unit-linked contracts (see paragraph BCA153(c)). That proposal is inconsistent with the IASB's general principle that the accounting for assets that the entity holds should not be affected by the entity's other assets and liabilities. However, respondents noted that, for many contracts that specify a link to returns on underlying items, those underlying items include a mix of assets. With the exception of own shares, own debt and owner-occupied property, respondents believed that those assets would all be measured at fair value through profit or loss. Thus, respondents believed there would be little benefit in an entity separately identifying its own shares, own debt and owner-occupied property and account for them differently, given that the returns to the policyholders are measured at fair value. Furthermore, the same effect on equity would be achieved for such contracts when either:

(a) the recognition and measurement basis of the entity's own shares, own debt and owner-occupied property is adjusted to be consistent with the liability, as proposed in the 2010 Exposure Draft; or

(b) the measurement of the liability is adjusted to be consistent with the measurement basis of the entity's own shares, own debt and owner-occupied property, as would be the case when paragraph 34 of this Exposure Draft is applied.

Accordingly, the IASB confirmed its proposal that an entity should be permitted to recognise and measure its own shares and owner-occupied property at fair value with the changes recognised in profit or loss. The IASB also extended this proposal to an entity's own debt, and to unit-linked contracts that are not insurance contracts. The IASB noted that doing so would be consistent with existing exemptions in IFRS, for example, in IAS 28 *Investments in Associates* for unit-linked contracts. However, in contrast to the FASB, the IASB does not propose any other specific requirements for unit-linked contracts. The FASB proposes specific requirements and exemptions for segregated fund arrangements (ie participation features within insurance contracts that are contractually linked to segregated accounts and that meet specific criteria) and the related segregated portfolios of assets, which are similar to unit-linked contracts.

BC50 The IASB does not think that it would be feasible to eliminate all accounting mismatches by modifying the accounting for all underlying items so that they are measured at fair value, other than for most unit-linked contracts. Many contracts specify a link to the performance of a business unit that includes items such as goodwill in subsidiaries, deferred tax assets or pension liabilities, and determining and understanding the fair value of such items for this purpose would be unduly onerous. Furthermore, most fair value options in IFRS require that fair value changes should be recognised in profit or loss. Since this Exposure Draft proposes that part of the change in insurance contracts would be recognised in other comprehensive income, this would mean that there are only limited circumstances in which an entity could eliminate mismatches in both measurement and presentation of the insurance contract through the exercise of fair value options. Accordingly, the IASB developed the proposals in paragraph 34 that would increase the circumstances in which it would be possible to eliminate accounting mismatches by modifying the accounting for the insurance contract.

Changes in value of options embedded in insurance contracts paragraph 66(b))

BC51 Some are concerned that the application of paragraphs 33–34 and 66 would mean that the insurance contract liabilities of different entities would not be comparable because of the differences in the measurement and presentation basis of underlying items. In particular, some are concerned that the proposal to modify the measurement and presentation of the fulfilment cash flows would mean that the measurement of the contract might not include the current value of options and guarantees; for example, when the underlying items are measured at cost or amortised cost.

BC52 However, the IASB noted that the proposal in paragraphs 33–34 and 66 to eliminate mismatches only applies to the fulfilment cash flows for which there is no possibility of economic mismatches. They would not apply to the

fulfilment cash flows that are not expected to vary directly with returns on underlying items. Those cash flows include those that result from options and guarantees embedded in insurance contracts. As a result, cash flows that result from options and guarantees embedded in insurance contracts would be measured in accordance with paragraphs 18–27, in other words, by using a risk-adjusted expected present value of future cash flows.

BC53 Nonetheless, the IASB proposes to address concerns about the transparency of changes in the current value of options and guarantees by requiring that changes in the fulfilment cash flows that are not expected to vary directly with returns on underlying items should be recognised in profit or loss.

Disclosures (paragraph 80)

BC54 The IASB proposes to require additional disclosure to supplement the disclosures about underlying items when the insurance contract requires the entity to hold underlying items and specifies a link to returns on those underlying items. Specifically, the IASB proposes that when the underlying items are not measured at fair value, but the entity is required (or chooses) to disclose the fair value of those underlying items, the entity should disclose the extent to which the difference between the fair value and the carrying amount of the underlying items would be passed to policyholders. Examples of assets for which such disclosures are required include financial assets and investment properties, if not measured at fair value. The IASB believes that such disclosure would be useful to inform users of financial statements that the policyholders have an economic interest in the difference between the fair value of the underlying items and their carrying amount.

BC55 The IASB also considered whether to require the disclosure of the current value of an insurance contract when the entity does not disclose the fair value of underlying items. However, in the IASB's view, disclosures about the current value of an insurance contract would be appropriate only if the entity discloses the fair value of all the underlying items. Disclosures of fair value would not be required if the underlying items include deferred tax, goodwill or future profits from contracts that do not provide cash flows that are expected to vary directly with returns on underlying items. In such cases, disclosing the policyholder share of the unrecognised value of the underlying items could be misleading because changes in the amounts disclosed would be driven by an unrecognised and undisclosed value on the asset side. Furthermore, such a disclosure is likely to be burdensome to measure, while not providing useful information to users of financial statements.

Consequences

Complexity arising from the need to decompose cash flows (paragraphs B85–B87)

BC56 The requirements in paragraph 34 of this Exposure Draft apply only when the contract requires the entity to hold underlying items and specifies a link to returns on those underlying items and only to the cash flows that are expected to vary directly with returns on those underlying items. However, such contracts often contain other features, such as minimum guarantees and fixed

or variable payments that are made on the occurrence of an insured event. The cash flows arising from those other features are not expected to vary with returns on underlying items. Thus, the proposals to eliminate the measurement and presentation mismatch would not apply to cash flows arising from those other features.

BC57 In principle, the proposals in the 2010 Exposure Draft would have allowed entities to apply different methods to measure the insurance contract, provided that those approaches resulted in information that was consistent with the objective of measuring the insurance contract on a market-consistent basis that incorporates all of the available information. However, the IASB's revisions to the proposals in the 2010 Exposure Draft would mean that an entity would be required to measure:

(a) the fulfilment cash flows that are expected to vary directly with returns on underlying items on the same basis as the carrying amount of the related underlying items; and

(b) the fulfilment cash flows that are not expected to vary with returns on underlying items on an expected value basis that takes into account all possible outcomes. Those fulfilment cash flows include options and guarantees embedded in the insurance contract.

The IASB is proposing these revisions because some methods that measure insurance contracts on a market-consistent basis may not provide the information that would be necessary to apply different measurement bases for different cash flows.

BC58 Any separation of cash flows is, to some extent, arbitrary. Measuring some cash flows on a market-consistent basis and other cash flows on a cost or amortised cost basis means that the application of different methods will result in different outcomes, each of which arguably meets the objective.

BC59 For example, if a contract promises to pay a policyholder a minimum of CU1,000 plus 90 per cent of the increase in fair value of the underlying items ('A') above an initial fair value of CU1,000, the cash flows could be decomposed in the following ways:[2]

(a) as a fixed amount plus a written call option, ie:

CU1,000 + [90% × the greater of (A − CU1,000) and CU0];

(b) as 100% of the assets plus the value of the guarantee (a written put option) less the value of the entity's 10% participation in the upside (a call option held), ie:

A + [the greater of (CU1,000 − A) and CU0] − [10% × the greater of (A − CU1,000) and CU0]; or

(c) as 90% of the assets plus a fixed payment of CU100 plus the value of the guarantee (a written put option), ie

[90% × A] + CU100 + [90% × the greater of (CU1,000 − A) and CU0].

2 In this Basis for Conclusions, currency amounts are denominated in 'currency units' (CU).

BC60 When applying the proposals in this Exposure Draft, the different decompositions illustrated in paragraph BC59 would result in different measurements of the insurance contract as a whole. They would also result in different amounts recognised in profit or loss and other comprehensive income (see paragraph BC121). Accordingly, the IASB proposes to specify that entities are required to decompose the cash flows in the contract using the approach in paragraph BC59(c) because it both:

(a) maximises the extent to which the cash flows are expected to vary with returns on underlying items; and

(b) identifies the minimum fixed payment that the policyholder will receive.

BC61 In contrast:

(a) in the approach that requires the decomposition of the cash flows as a fixed amount plus a call option (see paragraph BC59(a)), the extent to which the cash flows are expected to vary directly with returns on underlying items is reported in the value of the call option held. Because those options would be measured on a market-consistent basis and recognised in profit or loss, that approach would not eliminate accounting mismatches arising from those cash flows and the underlying items.

(b) in the approach that requires the decomposition of the cash flows as 100 per cent of the assets plus a guarantee and less the value of the entity's participation (see paragraph BC59(b)), all the fixed cash flows are reported in the value of the guarantee. Although some regard this approach as simpler to implement than the IASB's proposals, it would be inconsistent with the IASB's proposal to recognise changes in discount rates on fixed cash flows in other comprehensive income, as described in paragraphs BC117–BC121. This is because the guarantee would be measured on a market-consistent basis and recognised in profit or loss.

BC62 Applying the requirement to measure and present expected cash flows that are expected to vary directly with returns on underlying items on a different basis from other cash flows can be operationally complex. The complexity is increased when the underlying items are accounted for using a mix of measurement attributes, for example, amortised cost and fair value. However, the result of applying those operationally complex requirements is that the statement of financial position faithfully represents the combined effect on the entity's equity of the link between the underlying item and the insurance contract, and the statement of profit or loss and other comprehensive income faithfully represents the effects of that link in profit or loss.

Other approaches considered but rejected

BC63 Paragraphs BC45–BC50 describe why the IASB proposes to require entities to measure and present the fulfilment cash flows that are expected to vary directly with returns on underlying items on the basis of the carrying amount of those underlying items, but only when the entity is required to hold the underlying items. The IASB considered but rejected the following approaches:

(a) adjusting the measurement and presentation of insurance contracts only when entities cannot apply existing fair value options in IFRS (see paragraph BC64);

(b) adjusting the measurement and presentation of insurance contracts in narrower circumstances, as proposed by the FASB (see paragraphs BC65–BC69); and

(c) adjusting the measurement and presentation of insurance contracts in wider circumstances, such as in cases in which the contract does not specify a link, or the entity does not hold the underlying items (see paragraphs BC70–BC71).

Adjusting fulfilment cash flows only when entities cannot apply existing fair value options

BC64 Because the proposals in paragraphs 33–34 and 66 of this Exposure Draft are intended to avoid accounting mismatches between the measurement and presentation of those cash flows that are expected to vary directly with returns on underlying items and those underlying items themselves, the IASB considered whether it should restrict those proposals to situations in which accounting mismatches are unavoidable. That would mean that entities could adjust the measurement of cash flows that are expected to vary directly with returns on underlying items only if the entity cannot measure those items at fair value, because there is no fair value option for that item. However, as noted in paragraph BC50, for most fair value options in IFRS, fair value changes are required to be recognised in profit or loss and, as a result, accounting mismatches would remain in profit or loss as a result of the presentation requirements for insurance contracts proposed in this Exposure Draft. Accordingly, the IASB rejected this approach.

Restricting the circumstances in which the entity would adjust the measurement of cash flows

BC65 In the FASB's approach, an entity adjusts the measurement of the insurance contract to eliminate accounting mismatches only if it has no discretion as to the amounts of cash flows ultimately paid to policyholders. The participation rights of such contracts should be measured based on the contractual features, adjusted to reflect the measurement of the underlying items in the statement of financial position, provided that those timing differences between measurement of the contractual features and the underlying item are expected to reverse and enter into future calculations of participating benefits.

BC66 Those proposals are designed to achieve the same objective as the IASB's proposals, which is to measure and present the part of the obligation that relates to the underlying items on the same basis as those underlying items. However, the scope of those proposals differs.

BC67 In most cases, the FASB's approach and the IASB's approach would result in the same outcome. However, when payments to policyholders are contractually based on the fair values of underlying items that are measured in general purpose financial statements at cost or amortised cost, the IASB's approach would measure the insurance liability in a way that reflects the cost-based

measurement of those underlying items, while the FASB's approach would not. This is because the FASB does not regard the difference between the expected payment to policyholders, which is based on the fair value of the underlying items, and the cost or amortised cost of those items to be a timing difference that would necessarily be expected to be reversed and enter into future calculations of participating benefits, and think it would be misleading to users of financial statements if the liability were measured on an amortised cost basis but the policyholder could demand payment equal to the fair value of the underlying item.

BC68 Furthermore, the FASB's approach would apply only to the level of returns contractually linked, and not to any additional discretionary amount of returns that the entity expects to pass to policyholders. For example, if a contract specifies that at least 80 per cent of returns must be passed to policyholders, and the entity expects to pass to the policyholder 90 per cent of the returns, the IASB would measure the cash flows relating to 90 per cent of the returns on the same basis as the underlying items. Under the FASB's approach, 80 per cent of the returns would be measured on that basis.

BC69 The IASB placed greater emphasis on an approach that eliminates the accounting mismatches for all cash flows that depend on underlying items in all insurance contracts that require the entity to hold underlying items and specifies a link to returns on those underlying items. That approach is consistent with the IASB's view that the measurement of an insurance contract is based on all the expected cash flows arising from the insurance contract and does not distinguish contractual cash flows from discretionary cash flows.

Widening the circumstances in which the entity would adjust the measurement of cash flows

BC70 Some respondents suggested that all fulfilment cash flows that are expected to vary directly with returns on underlying items held by the entity should be adjusted to reflect the measurement basis of the underlying items, even if the contract does not specify a link between them. Some also suggested that the exception should apply to all the cash flows in eligible contracts and not only those that are expected to vary directly with returns on underlying items. However, in the IASB's view, the justification for adjusting the measurement basis for liabilities is that there could be no economic mismatches between the liabilities and the assets. That justification does not apply when:

(a) the entity is not required to hold the underlying items. Although the entity could choose to reduce economic mismatches by holding the underlying items, the possibility of economic mismatches arises if it does not hold the items.

(b) the contract does not specify a link to the underlying items. The entity may choose to set the cash flows from the contract in a way that reflects the returns on underlying items, but the possibility of economic mismatches arises if it does not.

(c) the cash flows are not expected to vary directly with returns on underlying items in all scenarios.

BC71 Accordingly, the IASB does not propose any adjustment to the measurement and presentation of fulfilment cash flows that are expected to vary directly with returns on underlying items, unless the entity is required to hold the underlying items, the contract specifies a link between the fulfilment cash flows and the returns on underlying items, and the cash flows are expected to vary directly with returns on those underlying items.

Significant changes to presentation since the 2010 Exposure Draft

BC72 This section discusses the following presentation issues on which the IASB seeks input:

(a) insurance contract revenue and expenses (see paragraphs BC73–BC116); and

(b) interest expense (see paragraphs BC117–BC159).

Other issues relating to the presentation of insurance contracts are discussed in paragraphs BCA224–BCA226 of Appendix A. The IASB is not seeking input on those other issues.

Insurance contract revenue and expenses (paragraphs 56–59 and B88–B91)

The need for insurance contract revenue

BC73 The 2010 Exposure Draft proposed a 'summarised-margin presentation' in the statement of profit or loss and other comprehensive income for most insurance contracts with a coverage period of more than one year. The summarised-margin presentation applies deposit accounting to the whole of an insurance contract. In other words, the summarised-margin presentation views all cash inflows associated with an insurance contract as deposits received from a community of policyholders and all the cash outflows as repayments to the community of policyholders. Neither the deposits nor the repayments would have been presented in the statement of profit or loss and other comprehensive income. Instead, the summarised-margin presentation would have presented separately the main sources of profit or loss arising from the change in the insurance contract. For contracts that are eligible for the premium-allocation approach, the 2010 Exposure Draft would have required entities to present insurance contract revenue and expense.

BC74 Many respondents to the 2010 Exposure Draft were concerned that the summarised-margin presentation would omit information about the premiums, claims and expenses from the statement of profit or loss and other comprehensive income for the period. That information would be provided only in the notes to the financial statements. Some stated that information about premiums, claims and expenses for the period was necessary to provide information about the gross performance of the entity (in contrast to information about net performance provided by the summarised-margin approach).

BC75 The IASB was persuaded that the financial statements of entities that issue insurance contracts would be more understandable and more comparable to other entities if the statements of comprehensive income were to provide information about gross performance. A consistent measure of gross performance would also increase comparability between entities that issue insurance contracts. Furthermore, many users of financial statements use measures of revenue to provide information about gross performance. Accordingly, the IASB proposes an approach that aims to provide a revenue measure for insurance contracts. This Exposure Draft refers to that measure as 'insurance contract revenue'.

BC76 The IASB proposes that the measurement of insurance contract revenue should be broadly consistent with the general principles in the 2011 Exposure Draft *Revenue from Contracts with Customers*. Consistently with that model, an entity would depict the transfer of promised coverage and other services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the coverage and other services. This means that the entity would:

(a) exclude from insurance contract revenue any investment components; and

(b) recognise insurance contract revenue in each period as it satisfies the performance obligations arising from the insurance contract.

BC77 The 2010 Exposure Draft noted the inherent challenges for some insurance contracts in identifying and measuring the progress in satisfying the performance obligations during the period. Some suggested that time-based methods for measuring progress, such as those typically used for other contracts, would faithfully depict the entity's progress in satisfying the obligations to provide coverage and other services. However, the IASB concluded that time-based methods would not reflect the fact that the value of the coverage and other services provided in each period may differ. The IASB noted that the liability for the remaining coverage represents the obligation to provide the remaining coverage and other services needed to fulfil the contract. As a result, the IASB concluded that recognising insurance contract revenue to the extent of a reduction in the liability for the remaining coverage, adjusted to eliminate changes that do not relate to the satisfaction of the performance obligation, would depict faithfully the entity's performance in providing coverage and other services. The adjustments to the liability for the remaining coverage exclude from total insurance contract revenue the part of the change in the liability for the remaining coverage that arises from losses on initial recognition or from changes in estimates of expected claims, to the extent that those changes are recognised in profit or loss. They ensure that the total insurance contract revenue presented over the duration of the contract is the same as the premiums received for services, adjusted for the time value of money.

BC78 The IASB considered whether each period's coverage should be treated as a separate performance obligation or whether the coverage for the entire contract should be regarded as a single performance obligation that would be satisfied over time. The conclusion would affect whether the amount of insurance contract revenue recognised in each period would be determined on the basis of initial estimates of the pattern of expected cash flows (see paragraph BC92), or

based on the most recent estimates in each period. Applying the principle from the 2011 Exposure Draft *Revenue from Contracts with Customers*, the IASB concluded that the obligation to provide coverage in any particular part of the entire coverage period would generally not be a separate performance obligation, and the coverage and services provided over the whole duration of the contract would generally be treated as a single performance obligation that is satisfied over time. When that is the case, a change in the pattern of expected cash flows would result in the entity updating its measure of progress and adjusting the amount of revenue recognised accordingly. That approach would also be consistent with the IASB's proposal to adjust the contractual service margin for changes in estimates of cash flows.

BC79 In the IASB's view, the proposals in this Exposure Draft are consistent with the core principle of the 2011 Exposure Draft *Revenue from Contracts with Customers*. In both Exposure Drafts, the statement of financial position reports the contract asset or contract liability, and the statement of profit or loss and other comprehensive income reports the progress towards satisfaction of the performance obligations in the contract:

(a) the 2011 Exposure Draft *Revenue from Contracts with Customers* establishes the amount of revenue that has been recognised each period and adjusts the contract asset or contract liability at the start of the period by the amount of revenue recognised to measure the contract asset or contract liability at the end of the period; and

(b) this Exposure Draft proposes a measurement model that would establish the contract position at the start and end of the reporting period. The amount of insurance contract revenue presented is measured by reference to these two measurements.

Disclosures relating to insurance contract revenue (paragraphs 73–82)

Reconciliation of components of the insurance contract liability (paragraph 74)

BC80 To determine insurance contract revenue on a basis that is consistent with the general measurement model proposed in this Exposure Draft and with the simplified approach in paragraphs 35–40, paragraph B88 requires an entity to disaggregate the insurance contract liability into components as follows:

(a) the liabilities for the remaining coverage, excluding the amounts in (b) below. For liabilities measured using the premium-allocation approach, this will be the unearned premium.

(b) the part of the liabilities for the remaining coverage recognised in profit or loss. This comprises amounts arising from losses on initial recognition and subsequent changes in estimates recognised immediately in profit or loss because they exceeded the amount of the contractual service margin. For liabilities measured using the premium-allocation approach, this will be the additional liability for onerous contracts.

(c) the liabilities for incurred claims.

BC81 The IASB proposes in paragraph 74 that entities should disclose a reconciliation from the opening to the closing balance of each of the components listed in paragraph BC80 in order to explain the amounts presented in the financial statements.

BC82 In addition, paragraph 76 would require an entity to disclose a reconciliation that shows the sources of profit for the period and separately reconciles the opening and closing balances of:

(a) the expected present value of the future cash flows;

(b) the risk adjustment; and

(c) the contractual service margin.

BC83 In response to the 2010 Exposure Draft, many respondents commented that reconciliations that show sources of profit would provide useful insight into an entity's insurance contracts because they would be directly related to the measurement model.

BC84 The IASB agrees. Furthermore, in the IASB's view, information about the change in the period of the components of the liability used in measurement is important in the light of:

(a) the decision to offset in the contractual service margin the effects of changes in estimates of future cash flows (see paragraphs BC26–BC41). As a result, those effects will not appear directly in the statement of profit or loss and other comprehensive income. Consequently, there is a greater need to understand how changes in estimates of cash flows affect the contractual service margin.

(b) the difference between the IASB's and the FASB's models for insurance contracts. Information about the change in the components of the liability provides reconciliations of the movements in the expected cash flows separately from the movements in the risk adjustment. This information would enable users of financial statements to compare the movements in the fulfilment cash flows of entities who apply the IASB's model to the movements in the fulfilment cash flows of entities applying the FASB's proposed model. Under the FASB model, the measurement of the insurance contract liability does not include an explicit adjustment for risk.

BC85 The proposals to require reconciliations derived from the information that is generated by the measurement model, in addition to the reconciliation of the components of the insurance contract used to determine insurance contract revenue, would mean that entities would need to disclose two types of reconciliations from opening to closing carrying amounts in the statement of financial position. The information to provide both reconciliations would be needed in order for the entity to comply with the measurement and presentation requirements, and respondents to the 2010 Exposure Draft

generally indicated that both would be useful. Consequently, the IASB concludes that the benefits of providing such information outweigh the costs of preparing two reconciliations.

The effect of new contracts issued in the period (paragraph 81(b))

BC86 Many believe that it would be useful for entities to disclose more than one measure of gross performance relating to insurance contracts. A measure of insurance contract revenue by itself does not provide all the information that users of financial statements seek, and may provide a misleading view of whether an entity's insurance contracts business is growing or shrinking. In particular, many users of financial statements find information about the amount of new business written in each period to be important when assessing the future prospects of an entity.

BC87 Some were concerned about the impression that would be given if the amount of insurance contract revenue were to increase while the amount of new contracts written decreased. They believe that, for contracts other than insurance contracts, the revenue would generally be recognised in a pattern that is more consistent with the pattern of cash received, because entities generally do not charge for services in advance. Thus they were concerned that users of financial statements would misinterpret insurance contract revenue if that amount is not consistent with the pattern of cash received. However, this effect occurs generally in accruals-based accounting for any contract that specifies payment in advance of services provided.

BC88 The IASB agrees that information about different measures of gross performance would provide useful information for users of financial statements, even though those measures might not be presented in the statement of profit or loss and other comprehensive income. Accordingly, the IASB proposes to require entities to disclose the premiums written during the period, disaggregated into the effect of those contracts on the fulfilment cash flows and on the contractual service margin. The premiums written is the amount of all expected premiums, including investment components, relating to contracts written in the period. Such disclosure would:

(a) provide useful information about the volume of sales that would supplement the insurance contract revenue presented in the statement of profit or loss and other comprehensive income; and

(b) allow users of financial statements to compare the volume of business written in prior years with the volume of contracts written in the current year.

BC89 In addition, the IASB proposes that entities should reconcile the insurance contract revenue to the premium receipts each period. The amount of the premium receipts would already be available to entities because they are required to reconcile contract balances. The IASB believes that there would generally be immaterial differences between the amount of the premium receipts and the premium due, which is the amount of the invoiced or receivable premium that is unconditionally due to the entity. The premium due

is a familiar measure used in some jurisdictions. Paragraphs BC105–BC107 explain why the IASB does not propose to use premiums due as the measure of insurance contract revenue.

Consequences

Excluding investment components from insurance contract revenue and incurred claims (paragraph 58)

BC90 One consequence of presenting any measure of gross performance on the statement of profit or loss and other comprehensive income is the need to consider whether to eliminate any investment components from that measure. An investment component is an amount that the insurance contract requires the entity to repay to the policyholder even if an insured event does not occur. Such obligations, if not included within an insurance contract, would be measured and presented in accordance with IFRS 9. The IASB believes that when an investment component is interrelated with the insurance components in an insurance contract, it is appropriate to measure the investment component and the insurance component in accordance with the proposals in this Exposure Draft. However, the IASB believes that it would not faithfully represent the similarities between financial instruments within the scope of IFRS 9 and investment components embedded in insurance contracts within the scope of this Exposure Draft if an entity were to present the receipts and repayments of such investment components as insurance contract revenue and incurred claims. To do so would be equivalent to a bank recognising a deposit as revenue. Accordingly, the IASB's proposals would exclude such investment components from insurance contract revenue and incurred claims.

BC91 Some are concerned that it would be too complex to separate interrelated cash flows and exclude some of them from insurance contract revenue and incurred expenses. The IASB considered whether complexity would be reduced if it chose a different approach to determining which cash flows should be excluded from insurance contract revenue and incurred expenses, such as by defining the investment component as the amount that the contract requires to be repaid when no insured event occurs. Using that definition, an entity would need to identify cash flows relating to an investment component only if it made a payment in the absence of an insured event. For example, if the entity pays the higher of an account balance and a fixed amount in the event of a policyholder's death, the whole of the payment that results from the policyholder's death would be regarded as relating to the insurance component rather than to the investment component. However, the IASB believes that defining an investment component in this way does not faithfully portray that the amount accumulated in the account balance through deposits by the policyholder is paid to the policyholder in all circumstances, including in the event of the policyholder's death. In the IASB's view, the insurance benefit is the additional amount that the entity would be required to pay if an insured event occurs, in other words, the difference between the account balance and the fixed amount both before and after the time of the insured event.

Insurance contract revenue recognised on the basis of expected claims and benefits

BC92 The IASB proposes that an entity should measure the satisfaction of its obligations in each period using the change in the measurement of the liability for the remaining coverage during each period. A consequence of this decision is that insurance contract revenue would be recognised partly on the basis of the expected cash outflows, which include the expected claims and benefits. Some expressed a view that the service provided by an insurance contract was inadequately represented by the change in the measurement of an entity's obligation to pay a claim when the insured event occurs. However, the amount reported as the liability for the remaining coverage represents the value of the obligation to provide coverage and other services. As a result, the IASB concluded that the reduction in the liability for the remaining coverage is a reasonable representation of the value of the performance obligation to provide coverage and services that was satisfied in the period.

Acquisition costs (paragraphs B89(a) and B90(d))

BC93 In many cases, the cash outflows associated with acquisition costs occur at the beginning of the contract coverage period before any coverage or other service has been provided. Because the services provided by a contract would be measured on the basis of expected cash outflows, the approach for determining insurance contract revenue might result in the entity recognising insurance contract revenue when those costs are incurred, often before the entity has provided any coverage or services under the contract.

BC94 The IASB noted that this outcome was consistent with the proposals in the 2010 Exposure Draft, which proposed that an entity would recognise acquisition costs as expenses when incurred and, at the same time, recognise the amount of premium equal to those costs. That proposal was consistent with the view that the premium that the policyholder pays for the contract has a component relating to the coverage that the entity provides and a component relating to the acquisition costs that the entity recovers. Furthermore, recognising acquisition costs as expenses and recognising the related amounts of premium when incurred would ensure that the measurement of identical insurance contract liabilities would be identical, regardless of the amount of expense incurred to acquire those liabilities.

BC95 However, because the proposals in the 2010 Exposure Draft proposed a net presentation of the margin from insurance contracts rather than a presentation of revenue and expenses, the issue that an entity would recognise insurance contract revenue before any services were provided did not arise. The 2011 Exposure Draft *Revenue from Contracts with Customers* proposed to prohibit the recognition of revenue before an entity has satisfied any performance obligations. To be consistent with those proposals, and to avoid recognising insurance contract revenue before any coverage has been provided, this Exposure Draft proposes that entities should, for presentation purposes, present the insurance contract revenue and expenses associated with such costs over the coverage period in line with the pattern of services provided under the contract, rather than when the costs are incurred. Because this allocation approach

applies only to the premium charged to cover such costs, and affects only the amount of insurance contract revenue and expenses that is grossed up from the margin, there is no recognition of an asset representing the acquisition of the insurance contract. In addition, no separate impairment test is needed to test the recoverability of such an asset (see paragraphs BCA45–BCA57 for a discussion of the treatment of cash flows relating to acquisition costs).

Recognition of incurred claims (paragraph 57)

BC96 The IASB believes that reporting claims and expenses when they are actually incurred is consistent with the reporting of expenses for other types of contracts and would provide useful information to users of financial statements. This would only be the case when insurance contract revenue is measured using the liability for the remaining coverage as a measure of progress towards satisfying an obligation.

BC97 When insurance contract revenue is measured in any other way, the incurred claims must be reconciled to the amount of expense that is presented in the period. This is because both insurance contract revenue and incurred claims and benefits are measures of changes in the insurance contract liability relating to coverage in the period. Thus, measuring insurance contract revenue as proposed in this Exposure Draft would mean that the uncertainty that is inherent in the measurement of insurance contracts, discussed in paragraph BC4, is reflected in the timing of insurance contract revenue, rather than in the amount of expense presented in the period. In contrast, measuring insurance contract revenue in any other way would mean that the uncertainty that is inherent in the measurement of insurance contracts would be reflected in the amount of expense presented in the period. Furthermore, any other measure of insurance contract revenue would include changes in the insurance contract liability relating to coverage in both the current and the future periods.

Premium-allocation approach

BC98 The proposed method of measuring insurance contract revenue should be measured on a basis that would be consistent with the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers* and that would allocate the premiums paid for services in a way that reflects the transfer of services provided under the contract. The simpler premium-allocation approach, also allocates customer consideration in a way that reflects the transfer of services provided under the contract. As a result, the insurance contract revenue presented for contracts accounted for using the main proposals in this Exposure Draft could be meaningfully combined with the insurance contract revenue for contracts accounted for using the premium-allocation approach. This is consistent with the IASB's view that the premium-allocation approach is a simplification to the general requirements of the proposed Standard. It is also consistent with the proposal to permit, rather than to require, the use of the premium-allocation approach for eligible contracts (see paragraphs BCA116–BCA124).

Complexity

BC99 In the IASB's view, the main disadvantage of requiring entities to present insurance contract revenue is likely to be the costs. In particular, when contracts are onerous, the measurement of insurance contract revenue requires entities to disaggregate the most recent estimates of expected cash flows, separating the original estimates from any later changes recognised in profit or loss. It also requires entities to track the unwinding of any losses on initial recognition of insurance contracts—these losses unwind as the claims are incurred. This requirement to track developments on onerous contracts separately could significantly increase the costs of applying the proposed Standard. That would not be required by the other approaches discussed in paragraphs BC101–BC116, which the IASB rejected for reasons noted there. The IASB notes that entities do not generally issue contracts that have losses on initial recognition, so the practical impact of this requirement is not expected to be widespread.

BC100 In addition, as described in paragraphs BC90–BC91, entities must identify investment components and exclude them from insurance contract revenue and from incurred claims presented in the statement of profit or loss and other comprehensive income. Some are concerned about the operational challenges of doing this. However, the IASB believes that these potential costs are outweighed by the following benefits of these proposals:

(a) many users of financial statements believe that reporting investment components as revenue would overstate revenue and could distort performance measures such as combined ratios. Accordingly, the IASB believes that there are significant benefits in distinguishing revenue from investment components (see paragraphs BCA204–BCA206).

(b) measuring insurance contract revenue at an amount that depicts the consideration transferred in exchange for providing coverage and other services in the period would increase consistency between the measurement and presentation of insurance contract revenue and the revenue from other types of contracts with customers within the scope of the 2011 Exposure Draft *Revenue from Contracts with Customers*. This would reduce the complexity of financial statements overall.

Other approaches considered but rejected

BC101 Many of the comment letters on the 2010 Exposure Draft criticised the summarised-margin approach proposed in that document because it did not provide a gross measure of performance in profit or loss.

BC102 Because the comments received generally supported the method for measurement of the net profit for the period, the IASB focused on how best to gross up the measurement to show a gross performance measure (insurance contract revenue) and information about the related cost (claims and benefits). This means that, regardless of the gross performance measure considered, the net profit for the period would be measured using the measurement model as proposed in this Exposure Draft. In other words, the amount of claims and

expenses presented in each period would be allocated to the revenue to ensure that the same net profit or loss for the period is reported.

Premium approaches

BC103 The IASB considered two approaches for presentation that are used in current practice:

(a) a written-premium presentation, which allocates the total expected insurance contract revenue to the period in which the contracts are initially recognised (written). At the same time, an expense is presented for the total expected claims and expenses relating to those contracts.

(b) a premiums-due presentation, which allocates the total expected insurance contract revenue to the periods in which the premiums become unconditionally due to the entity. At the same time, the entity recognises an allocation of the total expected expense on the basis of the amount of the premium recognised compared with the expected total revenue.

BC104 Some note that a written-premium presentation provides information about new business during the period, including the expected present value of the amounts to be received and the obligations assumed. However, the IASB rejected this approach because the premiums, claims and expenses presented in the statement of profit or loss and other comprehensive income are not measured by applying commonly understood notions of revenue and expenses. In particular, the revenue is recognised before the entity has performed a service and the claims and expenses are recognised before they have been incurred.

BC105 Many entities that issue long-duration insurance contracts currently apply a premiums-due presentation in the statement of profit or loss and other comprehensive income. Some argue that a premiums-due approach is useful because:

(a) the purpose of a gross performance measure is to measure growth and provide a denominator for claims and expenses ratios. A measure based on premiums due is objective, sufficient for that purpose and is simpler to provide than insurance contract revenue.

(b) it provides information about the additional premiums for insurance coverage and other services to which the entity has an unconditional right.

BC106 However, the IASB rejected this approach because:

(a) the gross performance measure presented using a premiums-due approach is not consistent with commonly understood concepts of revenue. As a result, it is likely to mislead non-specialist users of financial statements.

(b) although the premiums-due presentation would be an objective gross performance measure, insurance contracts give rise to inherently uncertain amounts. In a premiums-due presentation, the uncertainty would be reflected in the claims and benefits presented. The IASB

believes that reporting claims and expenses when incurred would provide useful information to users of financial statements, as discussed in paragraph BC96.

(c) when an entity uses the premiums-due presentation and also presents claims and benefits on an incurred basis, it must reconcile those amounts to remove the effects of changes in the insurance contract liability relating to coverage in a future period from the premiums due.

(d) a revenue measure generally does not provide information about unconditional rights to payments. Instead, the revenue measure provides information on when the entity provides goods or services to customers. In a premiums-due approach:

(i) the revenue would typically be recognised before the entity has performed the corresponding service, with corresponding claims and expenses being recognised before they have been incurred; and

(ii) the amounts presented as insurance contract revenue and claims, benefits and expenses vary depending on when a contract requires payment of the premium. For example, if a premium is due at the start of the contract, then all revenue and expenses are presented in the period that the contract is issued. If the premium is instead due annually, the revenue and expenses are presented at that point in each year. Thus, revenue and expenses may not indicate when the entity performs the service.

BC107 Although the IASB notes that some of the information provided by a premiums-due approach may be useful, it concluded that, if a gross performance measure is to be presented in profit or loss, it must be measured in a way that is consistent with commonly understood notions of revenue and expense. However, because the IASB concluded that other measures of gross performance could be useful, it proposes to require supplementary disclosure of other measures of gross performance (see paragraphs BC86–BC89).

Presenting insurance contract revenue for some contract types

BC108 The 2010 Exposure Draft proposed that an entity would be prohibited from presenting in the statement of profit or loss and other comprehensive income revenue and claims and other related expenses, except for contracts that were measured using the premium-allocation approach, for the following reasons:

(a) the premium-allocation approach is an allocated customer consideration approach similar to that proposed in the 2011 Exposure Draft *Revenue from Contracts with Customers*. When an entity applies the premium-allocation approach, the amount and timing of insurance contract revenue would be straightforward to measure, consistent with the recognition and measurement requirements of other types of revenue transactions and familiar to many users of financial statements.

(b) when considering contracts that are not eligible for the premium-allocation approach, insurance contract revenue is an unfamiliar concept, which has not been previously used by users of

financial statements. Measuring insurance contract revenue could significantly increase operational costs because the information required to do so is not needed to apply the other proposals in the Exposure Draft.

BC109 However, requiring insurance contract revenue for some contracts and not for others may result in a reporting difference that does not faithfully represent the economic differences between similar contracts, when the entity could apply either approach to a qualifying contract. Accordingly, the IASB proposes that entities should present insurance contract revenue for all insurance contracts.

BC110 For similar reasons, the IASB rejected an approach that would permit an option for entities to present insurance contract revenue if they believe that the benefits of doing so do not exceed the costs.

Treating all premiums as deposits (summarised-margin presentation)

BC111 Much of the complexity in the IASB's proposals arises from the need to eliminate investment components from measures of revenue. Investment components may be more significant in some contracts than in others. For example, significant investment components exist in many longer-term life insurance contracts and in some large longer-term, or bespoke, non-life insurance or reinsurance contracts. Some argue that any attempt to distinguish between investment components that have not been separated and the premium charged for insurance and other services would be arbitrary and complex to apply (see paragraphs BC99–BC100).

BC112 In contrast, the summarised-margin presentation that was proposed in the 2010 Exposure Draft treats all payments that arise in an insurance contract as repayments of deposits. This is operationally less complex than any presentation that provides a gross performance measure in the statement of profit or loss and other comprehensive income. This is because the summarised-margin presentation would not need to draw a line between investment components and premiums for services provided.

BC113 Another advantage of the summarised-margin approach is that it would link clearly to the measurement approach for the insurance liability in the statement of financial position, because it would separately report:

(a) income from the entity's performance under the contract as it is released from risk and as it provides other services;

(b) changes in circumstances that exceed the contractual service margin, together with any differences between estimates at the end of the previous reporting period and actual outcomes; and

(c) the interest expense on insurance liabilities, presented or disclosed in a way that highlights the relationship with changes in discount rates and with the investment return on the assets that back those liabilities.

BC114 Furthermore, the summarised-margin approach would not need an exception for the treatment of acquisition costs (see paragraphs BC93–BC95) to avoid a situation in which an entity recognises insurance contract revenue before the coverage has been provided.

BC115 Some contend that the lack of comparability between existing insurance presentations and revenue amounts reported by companies in other sectors is not a significant disadvantage to users of financial statements of entities that issue insurance contracts. In their view, users of financial statements do not compare the results of entities that issue insurance contracts with those of other entities. Instead, many users of financial statements that specialise in the insurance sector rely on the disaggregated information in the notes to the financial statements and expect to derive little value from the information reported in the statement of profit or loss and other comprehensive income because:

(a) the accounting models for life insurance contracts, unlike those for other transactions, typically measure the profit from insurance contracts directly through the release of the risk adjustment and the release of the contractual service margin. In contrast, the profit from other transactions is measured as the difference between revenue and expense.

(b) some believe that the most meaningful measure of gross performance and growth for insurance contracts is one that measures total premiums, which include both revenue and investment components. Such measures give information about the total increase in assets under management. However, those with this view accept that this measure is inconsistent with revenue and therefore accept that this information should not be presented in the statement of profit or loss and other comprehensive income. It would instead be reported in the notes to the financial statements and elsewhere.

BC116 Nonetheless, the summarised-margin approach would be a significant change from current practice, and was widely criticised in the comment letters on the 2010 Exposure Draft. The information that the IASB obtained in the response to its 2010 Exposure Draft was that, although many respondents thought that information about net margins was useful, they believed that this information was more suitable for the notes. In addition, the IASB noted that:

(a) insurance contracts combine service and investment elements. Entities recognise revenue when they satisfy their obligation to perform services under a contract. The summarised-margin approach would not present any amounts as revenue or expense in the statement of profit or loss and other comprehensive income. As a result, the summarised-margin approach would not faithfully represent the extent to which an entity provides services under an insurance contract.

(b) a summarised-margin approach, or a substitute for revenue that is unique to insurance contracts, reduces the comparability across the financial reporting for insurance contracts and the financial reporting for other contracts; and

(c) many of those who report, use and quote financial measures expect such financial measures to include a measure of gross performance. If the IASB does not require the presentation of an amount that is measured

using principles that are applicable to revenue from contracts with customers, preparers and sell-side analysts might substitute other measures for them.

Interest expense in profit or loss (paragraphs 60(h) and 61–65)

BC117 The 2010 Exposure Draft proposed a current measurement for insurance liabilities with all changes in the liability recognised in profit or loss. However, many respondents were concerned that gains and losses from underwriting and investing activities would be obscured by more volatile gains and losses arising from changes in the current discount rate that is applied to the cash flows in insurance contracts. In particular, these respondents noted that, when the amounts paid to the policyholder do not depend on market interest rates, changes in discount rates cause changes in the present value of cash flows, even though the ultimate amount paid to policyholders does not change.

BC118 Furthermore, in the responses to the 2010 Exposure Draft, many preparers expressed the concern that the requirement to use a current value measurement for insurance liabilities, specifically to remeasure insurance contract liabilities for changes in interest rates, would mean that entities would be forced to exercise the fair value option for financial assets in order to avoid the accounting mismatches that would arise between assets measured at amortised cost and insurance contract liabilities. They noted that the IASB has indicated that amortised cost is an appropriate measure for financial assets in some circumstances and that IFRS would generally require an entity to measure financial liabilities at amortised cost. Accordingly, they believe that the volatility in profit or loss that would result from a current value measurement of insurance contracts would not result in a faithful representation of their economic performance and would not provide comparability across entities without significant insurance contract liabilities.

BC119 The IASB is unconvinced that entities that issue insurance contracts would be disadvantaged if insurance contracts were to be measured at current value. However, the IASB was persuaded that entities should segregate the effects of changes in the discount rate that are expected to unwind over time from other gains and losses, so that users of financial statements could better assess the underwriting and investing performance of an entity that issues insurance contracts. The IASB believes that such segregation could be achieved by approximating an amortised cost view of the time value of money to be recognised in profit or loss. Thus, an entity would:

(a) report a current view of performance in total comprehensive income; and

(b) recognise in other comprehensive income the difference between the effects of discounting the cash flows at a current rate at the end of the period and the amortised cost view of the time value of money.

BC120 This would separate the effects of changes in cash flow estimates from the effects of changes in discount rates and would provide users of financial statements with information about the time value of money that the entity determined at contract inception.

BC121 Similar to financial assets mandatorily measured at fair value through other comprehensive income in accordance with the 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)), the amounts recognised in profit or loss and other comprehensive income would differ depending on the characteristics of the cash flows arising from the insurance contract:

(a) some payments to policyholders are not expected to vary with changes in interest rates. The interest expense recognised in profit or loss would be measured using the discount rate at contract inception. This is similar to the way the interest revenue is measured for a fixed-rate financial asset (see paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement*). The difference between the effects of discounting those cash flows at a current rate at the end of the period and the effects of discounting those same cash flows at the rate that applied at initial recognition would be recognised in other comprehensive income and would unwind automatically over time. This is similar to recognising gains or losses in other comprehensive income for financial assets mandatorily measured at fair value through other comprehensive income (see paragraph 5.7.1A of the 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010))).

(b) some cash flows in a contract are expected to vary with returns on underlying items. Changes in interest rates for underlying items that affect the returns on those underlying items may cause changes in the cash flows in an insurance contract. These cash flows have similar economic features to floating rate interest payments on financial instruments. As a result, the IASB believes that portraying the interest expense as if it resulted from a financial instrument with a fixed interest rate would not provide useful information. Accordingly, the IASB decided that, when the estimates of cash flows are expected to vary with returns on underlying items, the discount rate applied in determining interest expense recognised in profit or loss on those cash flows should be updated when the entity revises the estimates of those cash flows. This is similar to the requirement in IAS 39 that, for floating rate financial assets, movements in market rates of interest alter the effective interest rate (see paragraph AG7 of IAS 39).

Interest-sensitive cash flows

BC122 The measurement of an insurance contract reflects changing expectations of the timing or the amount that will be paid to policyholders as the contract is settled. Those changes reflect changes in estimates of, for example mortality rates, lapse rates and the frequency and severity of claims, some of which can be correlated with the discount rates that are used to discount the fulfilment cash flows. For

example, the estimates of cash flows that arise as a result of interest rate guarantees and options would vary when interest rates change. Similarly, interest rate changes may affect crediting rates or lapse rates.

BC123 Some suggest that all changes in the liability that result from changes in interest rates, including the effect of changes in interest rates on such interest-sensitive cash flows, should be isolated and recognised in other comprehensive income. Those with this view suggest that this would produce more useful information for users of financial statements because the total effect of changes in interest rates is recognised in other comprehensive income.

BC124 However, using other comprehensive income to recognise the effect of changes in interest rates on interest-sensitive cash flows in other comprehensive income would mean that the amounts included in other comprehensive income would not unwind over time. This is because the changes in interest rates would result in changes in the payments to policyholders. This approach would therefore be inconsistent with the IASB's rationale for recognising changes in other comprehensive income, which is that underwriting and investing performance should be segregated from changes that unwind over time.

Cash flows where no economic mismatches can arise (paragraphs 33–34 and 66)

BC125 Paragraphs BC45–BC62 describe the accounting requirements for contracts in which:

(a) the entity is required to hold the underlying items; and

(b) the cash flows to policyholders are expected to vary directly with returns on those underlying items.

BC126 For those contracts, the IASB's general conclusions for interest expense (described in paragraphs BC117–BC121) and for adjusting the contractual service margin for changes in cash flows (described in paragraphs BC26–BC32) do not apply. Instead the entity presents changes in the fulfilment cash flows in accordance with paragraph 66.

Consequences

Complexity

BC127 The IASB's revised proposals respond to comments on the 2010 Exposure Draft. However, they would introduce more reporting complexity than the 2010 Exposure Draft, which proposed to recognise all changes in the insurance contract liability in profit or loss. This reporting complexity could reduce the usefulness of the financial statements to users of financial statements, specifically:

(a) some are concerned that the effect of the accounting mismatches would obscure the entity's underwriting and investment performance. This is because, except in the limited circumstances described in paragraph BC46, entities would not be able to avoid accounting mismatches when the assets that back the insurance contracts are measured other than at fair value through other comprehensive income.

(b) some are concerned that information about the effect of duration mismatches and some options and guarantees embedded in insurance contracts would be obscured, because part of those effects would be recognised in other comprehensive income and part in profit or loss. This concern is exacerbated because this Exposure Draft would recognise changes in the value of some options embedded in insurance contracts wholly in profit or loss if the contract requires the entity to hold underlying items and specifies a link to those underlying items. Thus, there would be an inconsistent presentation of changes in the value of options and guarantees embedded in insurance contracts, depending on whether the options and guarantees are embedded in a contract that requires the entity to hold underlying items and specifies a link to returns on those underlying items.

(c) some believe that the amount recognised in other comprehensive income would be difficult to understand because it combines the effects of changes in discount rates for the period with the effect of the unwinding of the cumulative difference between the original and current rates. This is equally the case for amounts recognised in other comprehensive income when financial assets are measured at fair value through other comprehensive income, as proposed in the IASB Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9*.

BC128 Furthermore, the proposals would introduce costs for many preparers of financial statements. Preparers would be required to measure the insurance contract liability on a current basis in the statement of financial position and on a different basis for presentation in profit or loss. The presentation basis would require preparers:

(a) to apply different discount rates to different contracts according to their date of initial recognition, rather than applying only the current discount rate to all cash flows; and

(b) to update the discount rate when the cash flows are expected to vary with returns on underlying items.

BC129 As with the proposals for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items, the IASB's proposals for interest expense would restrict the entity's ability to apply different approaches to measure the insurance contracts, described in BC57. This is because a single discount rate and a single approach to discounting may not represent faithfully the cash flows of a contract if that contract generates different sets of cash flows and those sets are expected to vary in different ways with returns on underlying items. As a result, entities would be required to identify the cash flows with different characteristics and:

(a) for the cash flows that are not expected to vary with returns on underlying items:

(i) recognise interest expense in profit or loss using the discount rates that applied when the contract was initially recognised; and

(ii) recognise in other comprehensive income the difference between discounting the cash flows using a current rate and discounting the cash flows using the rate in (i).

(b) for the cash flows that are expected to vary directly with returns on underlying items:

(i) recognise interest expense in profit or loss using the discount rates that applied when the contract was initially recognised. The discount rates are updated when the entity expects changes in the returns on underlying items to affect the amount of the cash outflows.

(ii) recognise in other comprehensive income the difference between discounting the cash flows using a current rate and discounting the cash flows using the rate in (i).

BC130 As noted in paragraph BC58, any decomposition of cash flows is, to some extent, arbitrary. The different ways in which an entity might identify which of the cash flows that are expected to vary directly with returns on underlying items would result in different amounts being recognised in profit or loss and other comprehensive income. Thus, to increase comparability, the IASB proposes a similar decomposition to determine the fixed cash flows in an insurance contract as would be applied in decomposing the cash flows in contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. That approach:

(a) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and

(b) identifies the minimum fixed payment that the policyholder will receive.

BC131 As a result, the effects of changes in the discount rates that are recognised in other comprehensive income for fixed cash flows are comparable for all insurance contracts.

BC132 The IASB concluded that this operational complexity is justified because segregation of gains and losses that are expected to unwind over time from other gains and losses would enable users of financial statements to understand the underwriting and investing performance of an entity that issues insurance contracts.

Other approaches considered but rejected

BC133 Paragraphs BC117–BC121 explain that this Exposure Draft places greater weight than did the 2010 Exposure Draft on separating underwriting and investing performance from changes that unwind over time. Before concluding on the proposal in this Exposure Draft, the IASB also considered:

(a) other approaches for segregating changes that arise from movements in discount rates from other gains and losses (see paragraphs BC134–BC147); and

(b) other approaches for determining the amount to be recognised in other comprehensive income (see paragraphs BC148–BC159).

Segregating changes that arise from movements in discount rates

BC134 The IASB considered the following other approaches for segregating changes that arise from movements in discount rates from other gains and losses:

(a) segregating changes that arise from movements in discount rates within profit or loss (see paragraphs BC135–BC141);

(b) permitting an option to recognise in profit or loss the interest expense that is measured using the current rate (see paragraphs BC142–BC145); and

(c) recognising interest income in other comprehensive income for all assets that back insurance contracts (see paragraphs BC146–BC147).

Segregating changes that arise from movements in discount rates within profit or loss

BC135 Some suggest that the IASB's proposals for segregating underwriting and investing performance from changes that unwind over time would cause operational complexity that is not justified for some entities. For example, some entities manage asset and liability portfolios with limited interest and duration risks, and the users of the financial statements of these entities may not be concerned about the limited reported volatility that would arise. Furthermore, some entities are accustomed to explaining reported volatility under their existing accounting practices. Thus, the users of the financial statements of some entities may not be concerned about reported volatility. Nonetheless, all entities would be required to apply the proposals in the proposed Standard and would be subject to the additional operational costs that would result from the proposal to disaggregate the effects of discounting in other comprehensive income.

BC136 Some maintain that the most effective way of reducing accounting mismatch would be to recognise all changes in the insurance contracts liabilities in profit or loss, as proposed in the 2010 Exposure Draft. Consequently, the reporting entity could reduce accounting mismatches by choosing to apply existing fair value options in IFRSs, for example, for financial assets or investment property.

BC137 Accordingly, some suggest that all entities should recognise all gains and losses in profit or loss, and those entities for which the distinction between underwriting and investing performance is important should instead use the flexibility offered in IAS 1 *Presentation of Financial Statements*, which permits entities to segregate information within profit or loss. For example, some suggest that useful, disaggregated information could be achieved by segregating components of the changes in the insurance liability within profit or loss. Some changes could be presented as operating profit. Other changes, such as the effects of changes in the discount rate, could be presented below the operating profit line, within profit or loss. Operating profit could be useful:

(a) to highlight underlying performance when the assets backing insurance contracts are measured at fair value through profit or loss; and

(b) to reduce the effects of the accounting mismatches in profit or loss when the assets backing insurance contracts are measured at fair value through other comprehensive income or amortised cost.

BC138 Those who support presenting all changes in profit or loss further believe that:

(a) regardless of whether changes in the discount rate are short or long term, those changes are economic and may be useful in analysing an entity's performance;

(b) while the recognition of changes in the discount rate in profit or loss may result in reported volatility in profit or loss, that volatility would be mitigated because accounting mismatches would not occur if an entity's assets were measured at fair value with changes recognised in profit or loss; and

(c) the use of other comprehensive income should be minimised, particularly because, at this time, there is no general principle for when it should be used, and because it adds complexity to reporting.

BC139 However, some responses to the 2010 Exposure Draft suggested that the operational and reporting complexity described in paragraphs BC127–BC132 would be outweighed by the benefits of more relevant and transparent information about the underwriting and investing performance of insurance contracts. In reaching the proposals in this Exposure Draft, the IASB placed greater weight on those arguments.

BC140 Furthermore, the IASB considered that it is beyond the reasonable scope of this project to develop a comprehensive definition of operating profit. That would require the IASB to consider whether to include or exclude many items that are not related only to insurance contracts. In addition:

(a) because operating profit is not defined elsewhere in IFRS, any such approach would create an industry-specific presentation for the statement of profit or loss and other comprehensive income, which would be inconsistent with the IASB's intention not to create an industry-specific Standard; and

(b) a separate presentation within profit or loss would not alleviate the operational complexity that is associated with the need to measure the components separately.

BC141 Accordingly, the IASB rejected this approach.

An option to recognise all gains and losses in profit or loss

BC142 The IASB considered whether it should make the presentation of changes in the insurance contract liability in other comprehensive income an option rather than a requirement. An option could either be unrestricted, or restricted to circumstances in which the exercise of the option would significantly eliminate accounting mismatches. Such options would ensure that preparers would not have to suffer the complexity that is inherent in the IASB's revised decisions if they believed that the information provided in their circumstances does not warrant the cost of the complexity.

BC143 However, the IASB concluded that an unrestricted option would result in a lack of comparability and could reduce transparency across entities that issue insurance contracts. The IASB's objective in requiring the presentation of the effects of changes in discount rates on the insurance contract liability in other comprehensive income is to separate underwriting and investing performance from the effects of the changes in those discount rates that unwind over time. That objective would not be achieved if entities were permitted an unrestricted option to recognise those changes in profit or loss.

BC144 Some suggested an approach similar to the existing option in IFRS 9 that permits an entity to measure a financial asset at fair value through profit or loss (the 'fair value option') if it reduces or eliminates accounting mismatches. However, the IASB observed that a similar option for insurance contract liabilities would be problematic because:

(a) applying such an option to an individual insurance contract is the best way to fully eliminate accounting mismatches. It is also consistent with the application of the fair value option for financial assets. However, applying such an option at an individual insurance contract level may be operationally complex and may not provide useful information. This is because insurance contracts and associated assets are typically managed at a more aggregated level. Nonetheless, it would be difficult to achieve the objective of reducing or eliminating accounting mismatches through the use of a fair value option for insurance contracts because accounting mismatches would not be eliminated overall if an entity applied an option to recognise in profit or loss all changes in the value of insurance contracts at:

(i) an entity level, because an entity may have different portfolios that it manages in different ways.

(ii) a portfolio level, because an entity may hold assets that are measured using a mix of measurement attributes (for example, at fair value through profit or loss, amortised cost or fair value through other comprehensive income) and the mix of measurement attributes in the portfolio may change over time. Accounting mismatches would be reduced only if the entity exercises the option to measure all the assets at fair value through profit or loss.

(b) it would be necessary to specify whether an entity should be permitted or required to invoke or revoke any such option, and in what circumstances. For financial assets, the application of the fair value option in IFRS 9 is available only at initial recognition and is irrevocable. This ensures that entities do not invoke or revoke the fair value option in a particular period to achieve a particular accounting result for that period. However, an irrevocable option would not necessarily reduce or eliminate accounting mismatches if the duration of insurance contracts and the assets backing the insurance contracts differed. An entity would only be able to assess whether the accounting mismatches would be reduced or eliminated when the duration of either the insurance contract or the backing assets ended. While the exercise of the option

might reduce accounting mismatches in the short term, it could exacerbate those accounting mismatches in later periods. This would be especially of concern because of the extent of the duration mismatches that might arise between assets and liabilities.

BC145 Consequently, the IASB concluded that permitting an option for entities to recognise all gains and losses from insurance contracts in profit or loss would introduce additional complexity for preparers to operate the option and for users of financial statements to understand the result. Taken together with the lack of comparability that would result from an option, the Board concluded that the cost of that complexity is not justified by the benefits of reduced mismatches for some entities. This would be the case regardless of whether the option was unrestricted, or restricted to circumstances in which the exercise of the option would significantly eliminate accounting mismatches.

Assets that back insurance contracts

BC146 Some suggest that measuring and reporting both assets and liabilities at fair value through other comprehensive income would segregate the effects of changes in the discount rate from other gains and losses while avoiding accounting mismatches.

BC147 While the IASB believes that accounting mismatches should be eliminated or reduced to the best extent possible, it noted that this would only be possible if either all the changes in the insurance contracts were recognised in profit or loss, as discussed in paragraph BC136, or if all of the assets that the entity holds to back those contracts were measured at fair value through other comprehensive income. In the IASB's view, it would not be appropriate to change the accounting for assets for an entity that issues insurance contracts, because:

(a) it would be undesirable to create industry-specific requirements for the accounting for assets, because doing so would reduce comparability between entities that issue insurance contracts and other entities; and

(b) identifying which of the entity's assets are held to back insurance liabilities introduces subjectivity and may be arbitrary.

Other approaches to measuring interest expense

BC148 The IASB's proposals would require an entity to recognise, in profit or loss, interest expense that is consistent with the interest revenue recognised for financial assets measured at fair value through other comprehensive income. The IASB also considered, but rejected, recognising in profit or loss interest expense measured:

(a) using the current discount rate at the start of each reporting period (see paragraphs BC150–BC153);

(b) using the discount rate at contract inception and accelerating the reclassification to profit or loss of amounts recognised in other comprehensive income when the entity expects that the assets viewed as backing the insurance contract liability will not produce sufficient

returns to fulfil the entity's obligation (sometimes called a 'loss recognition test'; see paragraphs BC154–BC157); and

(c) using the book yield (see paragraphs BC158–BC159).

BC149 The FASB proposes updating the discount rates to rates that recognise estimated interest crediting on a level yield basis over the remaining life of the portfolio of contracts when the entity expects changes in the expected returns on underlying items to affect the amount of the cash flows to the policyholder. The IASB did not consider that approach. After the date that the cash flows are updated, the mechanics of that approach would recognise in profit or loss interest expense that is determined in a different way from how interest expense is determined in the period prior to the first updating of those cash flows. In addition, this approach would recognise some changes in cash flow estimates (ie those attributable to estimated interest crediting) in other comprehensive income or as an adjustment to the contractual service margin as appropriate. This is inconsistent with the recognition of other cash flow changes immediately in profit or loss.

Current discount rate at the start of each reporting period

BC150 The IASB considered an approach in which:

(a) interest expense recognised in profit or loss on the insurance liability would be based on the current discount rates at the start of the reporting period, applied to the carrying amount at the start of the period; and

(b) the effects of changes in the discount rate during the reporting period on the insurance liability would be recognised in other comprehensive income.

BC151 Proponents of this approach believe that it would provide useful information to users of financial statements, because it would isolate in other comprehensive income only the effects of changes in the discount rate in the current period.

BC152 However, the IASB rejected this approach for the following reasons:

(a) amounts recognised in other comprehensive income would not unwind over the life of the contracts that generated them.

(b) it would introduce accounting mismatches in profit or loss. These accounting mismatches would arise because the interest expense recognised in profit or loss for the insurance contract would be measured using the contract's discount rate at the start of the reporting period (the 'current rate'). The interest income for the assets would be based on a rate that is determined on initial recognition if those assets are required to be measured at amortised cost or at fair value through other comprehensive income.

(c) entities that issue insurance contracts would need to measure their assets at fair value through profit or loss to reduce accounting mismatches with insurance contract liabilities measured at current value. As noted in paragraph BC118, some entities that issue insurance contracts believe that a requirement to measure their insurance contracts at current value would mean that entities would be forced to

exercise the fair value option for financial assets. These entities believe that amortised cost is the most appropriate measurement basis for assets held to collect principal and interest.

BC153 The IASB concluded that this approach has no advantage over an approach that recognises interest expense based on the current discount rate at the end of the reporting period, and would be more complex to implement.

Accelerating reclassification of amounts recognised in other comprehensive income

BC154 Some note that if the assets viewed as backing the insurance contract liability are measured at fair value through other comprehensive income, and the effects of the discount rate changes for the insurance liabilities are reported initially in other comprehensive income, any net losses that arise because the entity expects that those assets will not produce sufficient returns to fulfil the entity's obligation will be reported initially in other comprehensive income. These losses appear in profit or loss as the difference between income and expense when the interest expense unwinds over the life of the contract and interest income is recognised. Some believe that such losses should instead be recognised immediately in profit or loss in the period in which the entity first estimates that the assets will not produce sufficient returns.

BC155 Accordingly, some suggest that the amounts recognised in other comprehensive income should be reclassified to profit or loss if the entity expects that the assets viewed as backing the insurance contract liability will not produce sufficient returns to fulfil the entity's obligations. Those with this view also believe that at that point the entity should reset the discount rate used to measure interest expense recognised in profit or loss to a current rate. Proposals from respondents varied about what the reset rate should be, depending on views about how and when to measure the amount of the shortfall that should be reclassified from other comprehensive income to profit or loss.

BC156 The IASB rejected proposals to accelerate the reclassification of losses from other comprehensive income to profit or loss because:

(a) there is no conceptual basis for accelerating the reclassification of losses on an insurance contract liability because of changes in the performance of assets.

(b) it would be inconsistent with the IASB's view that the cash flows of the assets that do not affect the cash flows of the liability should not be considered in the measurement of the liability (and vice versa), and that the measurement of cash flows arising from insurance contracts should reflect only the characteristics of those cash flows.

(c) accelerating the reclassification of losses to profit or loss from other comprehensive income would not provide neutral information, because it would treat gains and losses differently. In addition, accelerating the reclassification of losses only in some circumstances would fail to take into account losses until the test is triggered.

(d) some entities do not designate assets to back specified insurance contracts or to back insurance contracts at a higher level of aggregation (for example, a 'grouping' of assets could be used to back several portfolios). These entities would need to segregate their assets to apply such an approach.

(e) the approach would mean that the interest expense in profit or loss may combine the effects of 'cost' and 'current' discount rates. Thus, users of financial statements would need to understand which expected cash flows had been discounted using a current discount rate and the reasons for the larger net profit, or lower net losses, in subsequent periods after those losses had been reclassified to profit or loss.

BC157 In addition, accelerating the recognition of losses from other comprehensive income to profit or loss would be inconsistent with the accounting requirements for financial instruments because:

(a) an impairment loss is not recognised for a financial asset (for example, a debt instrument) if it is funded by liabilities that have an effective interest rate that is higher than the rate that is applicable for the asset.

(b) if the assets purchased by an entity are funded by a liability that is measured at amortised cost, the effective interest rate of that liability is not reset if the subsequent returns on the assets are lower than the effective interest rate for the liability.

(c) as a result of (a) and (b), such a test may reduce comparability between entities that issue insurance contracts and those that do not.

Resetting the discount rate to the book yield

BC158 Some preparers propose that, when the cash flows of a contract depend on underlying items, the interest expense that is recognised in profit or loss should be determined using the 'current portfolio book yield' of those underlying items. The current portfolio book yield is:

(a) the rate that is reported in profit or loss, that is, a market yield for assets that are measured at fair value through profit or loss and an amortised cost-based yield for assets that are measured at amortised cost or at fair value through other comprehensive income; plus

(b) adjustments for expected/unexpected defaults and expected reinvestment rates when assets and liabilities do not match.

BC159 However, the IASB rejected this approach because:

(a) the current portfolio book yield differs from the discount rate that is applied to the cash flows of the insurance contract. Recognising interest expense in profit or loss measured using a discount rate that has no relationship to the rate that is used to measure the insurance contract does not provide useful information because the amount of interest expense that is recognised on a cumulative basis might not equal the amount of discount that is accreted on the liability. This is because the amount of interest expense is a function of the accounting basis for the underlying items. Consequently there would be a 'permanent' difference

between the interest expense that is cumulatively recognised and the amount of discount that is accreted on the liability.

(b) changes in the book yield would not necessarily trigger a change in the interest that is credited to policyholders. Reporting changes in the interest expense that are unrelated to changes in the measurement of the insurance contract would be difficult for users of financial statements to understand.

(c) it may be difficult to identify the assets that are held by the entities to back insurance liabilities, as discussed in paragraph BC147(b).

Applying the proposals for the first time (paragraphs C1–C13)

Modified retrospective approach (paragraphs C2–C6)

BC160 The proposed measurement model comprises two elements:

(a) a direct measurement, which is based on estimates of the present value of future cash flows and an explicit risk adjustment; and

(b) a contractual service margin, which is measured at initial recognition of the insurance contract, adjusted for subsequent changes in estimates relating to future services and recognised in profit or loss over the coverage period.

BC161 In addition, the proposed presentation approach would include in profit or loss:

(a) insurance contract revenue, which is measured as the change in the liability for the remaining coverage excluding losses on initial recognition and changes in estimates that are not offset in the contractual service margin;

(b) an allocation of the acquisition costs and the related insurance contract revenue that is based on the pattern of transfer of services under the contract;

(c) claims and expenses on an incurred basis; and

(d) interest expense, measured using the discount rate at the date of initial recognition of the contract, updated if the entity expects any changes in the returns on underlying items to affect the amount of cash outflows.

BC162 In general, when an entity applies accounting policies that result from a new Standard for the first time, the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would apply, unless another Standard contains more specific requirements. IAS 8 requires retrospective application of a new accounting policy except when it would be impracticable. When it is impracticable, IAS 8 requires an entity, at the beginning of the current period, to measure the cumulative effect of applying a new accounting policy to prior periods, and to adjust the comparative information so that the new accounting policy is applied prospectively from the earliest date practicable. The entity therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity that arise before the date at which it would be practicable to apply the Standard retrospectively.

BC163 The IASB has identified no specific transition problems for the introduction of the direct measurement component of the insurance contract. That measurement reflects only circumstances at the measurement date. Consequently, provided an entity has sufficient lead time to set up the necessary systems, performing that direct measurement on transition to the new model will be no more difficult than performing that measurement on a later date.

BC164 Measuring the remaining amount of the contractual service margin at the date of transition, and the information needed for presentation in the statement of profit or loss and other comprehensive income in subsequent periods, is more challenging. In principle:

(a) an entity would measure the remaining contractual service margin by:

(i) estimating the fulfilment cash flows at initial recognition of the contracts;

(ii) estimating the amount by which the contractual service margin at initial recognition would have been adjusted to reflect changes in estimates of expected future cash flows before the date of transition; and

(iii) estimating the amount of contractual service margin that would have been recognised in profit or loss in the periods before the date of transition.

(b) an entity would determine insurance contract revenue to be recognised in periods after the date of transition as the carrying amount of the liability for the remaining coverage at the date of transition less the portion of that carrying amount that arose from expected losses that were recognised:

(i) as an immediate expense at contract inception; and

(ii) as a result of changes in estimates of claims, benefits and expenses after contract inception.

(c) an entity would measure the interest expense recognised in profit or loss by estimating the discount rate when the contract initially was recognised, or updated as a result of changes in expectations of cash flows that the entity expected to credit to the policyholder, and applying that discount rate to the fulfilment cash flows.

BC165 The IASB believes that measuring the following amounts would often be subject to bias through the use of hindsight:

(a) the expected cash flows at the date of initial recognition;

(b) the risk adjustment at the date of initial recognition;

(c) the discount rate at the date of initial recognition; and

(d) for each accounting period, the changes in estimates that would have been recognised in profit or loss because they did not relate to future coverage, and the extent to which such changes in estimates would have been reversed as claims were incurred.

BC166 As a result, the IASB concluded that, for many contracts, retrospective application of this Exposure Draft would often be impracticable, as defined in IAS 8.

BC167 In the 2010 Exposure Draft, the IASB proposed that an entity should, when first applying the new Standard, measure its existing contracts at that date by setting the contractual service margin equal to zero.

BC168 However, most comment letters to the 2010 Exposure Draft criticised this approach because it would result in a significant lack of comparability between contracts that were in force at the date of transition and those that were recognised initially after the date of transition. The effects of this lack of comparability would be present for many years to come because of the long duration of insurance contracts.

BC169 The IASB was persuaded by the arguments that there would be a lack of comparability in the measurement, both at transition and subsequently, of contracts that were written before and after the date of transition. In particular, the IASB was persuaded that when an entity first applies a new Standard, subject to cost-benefit considerations, the primary focus should be on consistency between:

(a) the measurement of the insurance contracts' liability and the contractual service margin on the insurance contracts in force at the date of transition and those for new contracts issued after transition; and

(b) the presentation of the insurance contract revenue and profit for the insurance contracts in force at transition and on new contracts issued after transition.

BC170 As a result, this Exposure Draft proposes that:

(a) where practicable, an entity should apply this Exposure Draft retrospectively in accordance with IAS 8.

(b) when retrospective application of this Exposure Draft is not practicable, an entity should apply a modified retrospective application of this Exposure Draft. This modified retrospective application would require entities to estimate the information needed to apply this Exposure Draft listed in paragraph BC165, maximising the use of objective data, and with the following simplifications:

(i) the entity should assume that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were known already at initial recognition. This simplification is equivalent to offsetting all changes in estimates of cash flows against the contractual service margin on a retrospective basis. This avoids the need for entities to measure the changes in estimates that would have been recognised in profit or loss because they did not relate to future coverage, or to assess the extent to which such changes in estimates had been reversed as claims were incurred. The IASB believes that entities could approximate the expected cash flows at the date of initial recognition without undue effort by

adjusting the expected cash flows at the date of transition by the cash flows that occurred before the date of the earliest period presented.

(ii) the risk adjustment at the date of initial recognition should be assumed to be the same as the risk adjustment at the date of the earliest period presented. This simplification would most likely understate the risk adjustment at the date of initial recognition. However, the risk adjustment at the date of transition could be more objectively determined than by any other approach for estimating what the risk adjustment would have been at the date of initial recognition.

(iii) the discount rate at the date of initial recognition should be estimated to be consistent with historical observable data from the date of initial recognition, averaged over a minimum of three years. The IASB observed that many entities that issue insurance contracts will have objective, contemporaneous data about insurance contracts issued before the date of transition. Such data would include actuarial reports and regulatory filings. Using such information would increase comparability between the accounting for contracts that are in force at the beginning of the earliest period presented and the accounting for contracts that are recognised initially after the beginning of the earliest period presented.

Other approaches considered but rejected

BC171 The IASB considered whether entities could measure the contractual service margin at the date of transition as the difference between the fulfilment cash flows and another measure of the insurance contract at the date of transition. Possible alternative measurements that were considered included fair value, the premium that the entity would have charged the policyholder if it had entered into a contract with equivalent terms, or the carrying amount under previous GAAP at the date of transition. Such other measurements would be determined at the date of transition and would not exclude the use of hindsight. Additionally, those other measurements:

(a) would not aim to provide comparability between contracts that are in force at the date of transition and contracts that are recognised initially after the date of transition;

(b) would not provide the information that is needed to measure insurance contract revenue; and

(c) would still require the IASB to specify simplifications.

BC172 Consequently, the IASB concluded that there would be minimal benefit in applying a different measurement of the insurance contract at the date of transition.

BC173 The IASB concluded that there is no need to constrain the amount of contractual service margin because the requirements, proposed in this Exposure Draft, to

use all of the available information to approximate retrospective application would be sufficient to ensure that the contractual service margin is not overstated.

Other transition issues

BC174 The IASB does not propose any specific application guidance on the level of aggregation for contracts that exist at the beginning of the earliest period presented. Thus, the level of aggregation would be the same as for contracts that are written after the beginning of the earliest period presented. In contrast, the FASB proposes that an entity may, as a practical expedient, measure the insurance contract liability and its margin using its determination of the portfolio immediately prior to transition.

Elimination of deferred acquisition costs and some other intangible assets (paragraph C3(a) and (b))

BC175 As proposed in the 2010 Exposure Draft, when an entity applies the new measurement model it would not only need to adjust the measurement of its insurance contracts but would also need to eliminate some related items such as deferred acquisition costs and some intangible assets that relate solely to existing contracts. The IASB decided that elimination of these items, if any exist, is appropriate because those items could be viewed as corrections for a previous overstatement of the insurance liability, and so their elimination is likely to coincide with a reduction in the measurement of the insurance liability.

Redesignation of assets (paragraphs C11–C12)

BC176 The IASB considered whether, upon the first application of these proposals, an entity should be permitted to revisit its elections and designations for financial assets that had previously been designated or classified in accordance with IAS 39 or IFRS 9.[3]

BC177 In the absence of any specific transition relief, any redesignation and/or reclassification would need to be consistent with the financial instruments Standard that the entity applies when it first applies these proposals:

(a) if the entity applies these proposals before it applies any version of IFRS 9, financial assets would be redesignated and/or reclassified in accordance with IAS 39; and

(b) if the entity applies these proposals after it applies a version of IFRS 9, financial assets would be redesignated and/or reclassified in accordance with that version of IFRS 9.

BC178 IFRS 9 does not permit either subsequent redesignation under the fair value option or subsequent redesignation of equity instruments into, or out of, the category of instruments at fair value through other comprehensive income. Changes in classification occur only as a result of a change in business model and would not occur because an entity applies a new accounting policy. Furthermore, IFRS 9 states that frequent assertions that an entity has changed

3 IAS 39 and IFRS 9 include requirements for the classification of financial assets. IAS 39 and IFRS 9 also include fair value options for entities to designate financial assets as measured at fair value.

its business model would be inconsistent with the IASB's view that "an entity's business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management".[4]

BC179 The interaction between the classification of financial assets and the presentation of changes in the insurance contract liability would affect the accounting mismatches that would be reported in profit or loss. On first applying the new insurance liability requirements, an entity would be able to reclassify financial assets only in accordance with the requirements in IAS 39 or IFRS 9. However, the IASB proposes that entities would be able to designate financial assets using the fair value option on first applying this proposed Standard to the extent that they would have been able to designate financial assets on first applying IFRS 9. In particular, the IASB proposes that, following earlier application of IFRS 9, an entity would be permitted to newly elect to use other comprehensive income to recognise changes in the fair value of some or all equity investments that are not held for trading, or to revoke such an election. As the criterion for this classification option does not refer to accounting mismatches, the IASB proposes that entities should be able to reconsider this election regardless of whether there is an effect on accounting mismatches. Even though accounting mismatches do not drive this classification option, in practice entities may consider accounting mismatches when deciding whether to apply the option.

Transition disclosures (paragraphs C7–C10)

Amounts recognised in financial statements (paragraphs C8 and C10)

BC180 There would inevitably be some differences in measurement when applying this modified retrospective approach to contracts that are in force at the date of transition, compared to applying these proposals to contracts initially recognised after the date of transition. Accordingly, the IASB proposes to require that an entity explains the extent to which amounts in the financial statements have been measured using the transition simplifications proposed.

BC181 As noted in paragraph BC162, entities would be required to make the disclosures required by IAS 8 when making the transition to the proposed Standard. However, the IASB decided that entities should not be required to disclose, for the current period and for each prior period presented, the amount of the adjustment for each financial statement line item affected, as required by paragraph 28(f) of IAS 8.

BC182 In the IASB's view, the cost of providing this disclosure, which would include the running of parallel systems, would exceed the benefits, particularly because IFRS 4 permits an entity to continue a wide range of existing practices and to select accounting policies for insurance contracts that result in information that is neither relevant nor reliable.

4 Paragraph BC4.20 of the Basis for Conclusions on IFRS 9.

Disclosure of claims development (paragraph C9)

BC183 Paragraph 44 of IFRS 4 exempted an entity from disclosing some information about claims development in prior periods on first-time application of that Standard. The IASB proposes to carry forward a similar exemption for cost-benefit reasons.

Effective date (paragraph C1)

BC184 The IASB generally allows at least 12–18 months between the publication of a new Standard and its mandatory effective date. However, the proposed Standard is a comprehensive change that would be pervasive for most entities that issue insurance contracts, and the task of implementing the proposals would be extensive. Consistently with the feedback received on the 2010 Exposure Draft, the IASB proposes to allow approximately three years between the date that the IASB finalises a Standard based on these proposals and the mandatory effective date of that Standard.

BC185 The IASB expects that the earliest possible mandatory effective date for the proposed Standard to be for accounting periods beginning on or after 1 January 2017. The IASB expects to reconsider the mandatory effective date for IFRS 9 when it completes its redeliberations on IFRS 9.[5]

BC186 Some interested parties believe that entities should not be required to implement IFRS 9 before implementing the Standard based on these proposals. However, in setting the effective dates of IFRS 9 and the Standard based on these proposals, the IASB will seek to avoid further delay to the mandatory effective date of IFRS 9 because:

(a) there is expected to be widespread benefit from the transparent and useful information that would result from the application of IFRS 9; and

(b) some entities have already begun to apply the classification and measurement proposals of IFRS 9. Postponing the mandatory effective date to accommodate the timing of these proposals would reduce comparability across entities.

BC187 Accordingly, as described in paragraphs BC176–BC179, the IASB proposes to mitigate the difficulties that an entity may experience when implementing these proposals after implementing IFRS 9.

BC188 The IASB will reconsider the interaction of the effective date of this Exposure Draft with the mandatory effective date of IFRS 9 before it issues the final Standard.

Comparative information (paragraph C4)

BC189 This Exposure Draft proposes that entities should present comparative information for all periods presented. However, because this Exposure Draft proposes retrospective application on transition if practicable, and specifies modifications to retrospective application when retrospective application is not

5 In the Exposure Draft *Financial Instruments: Expected Credit Losses* published in March 2013, the IASB asked how much time entities would need to implement IFRS 9. The IASB intends to reconsider the mandatory effective date of IFRS 9 in the light of the responses to that question.

practicable, restatement of comparative financial statements would not require significant incremental time and resources.

Early application (paragraph C1)

BC190 IFRS 4 permits an entity to change the accounting policies for insurance contracts if it shows that the change results in more relevant or reliable information. As a result, IFRS 4 would permit an entity to apply the proposals in this Exposure Draft, except for the proposals relating to other comprehensive income and the transition relief. Accordingly, the IASB concluded that it would not be appropriate to prohibit early application of the proposals in this Exposure Draft.

First-time adopters of IFRS (Appendix D)

BC191 The proposed transition requirements would apply both to first-time adopters of IFRS and to entities that already apply IFRS. The IASB sees no reason to treat first-time adopters differently in this respect. Consequently, the IASB has amended IFRS 1 *First-time Adoption of International Financial Reporting Standards* to require the modified retrospective application of this Exposure Draft when retrospective application of this Exposure Draft is impracticable, as defined by IAS 8.

Appendix A
Basis for Conclusions on areas on which the IASB is not seeking input

Introduction

BCA1 The Basis for Conclusions in paragraphs BC1–BC191 focuses on the issues that the IASB plans to reconsider when it discusses responses to this Exposure Draft. This appendix summarises the IASB's reasoning for the topics on which it is not specifically seeking feedback. Individual IASB members gave greater weight to some factors than to others.

BCA2 This appendix first discusses the IASB's proposals on how an entity measures an insurance contact. It then discusses how the IASB's conclusions on measurement affect the other proposals in this Exposure Draft, other than those for which the IASB is seeking feedback.

Developing a new measurement model for insurance contracts

BCA3 The IASB considered the following approaches to developing an accounting model for insurance contracts:

(a) applying generally applicable Standards (see paragraphs BCA5–BCA15);

(b) a bifurcation approach (see paragraphs BCA16–BCA17);

(c) a predominant component approach (see paragraph BCA18);

(d) a fair value approach (see paragraph BCA19); and

(e) selecting an existing model for accounting for insurance contracts, such as existing US GAAP (see paragraphs BCA20–BCA21).

BCA4 However, as discussed in the paragraphs that follow, the IASB believes that those approaches would not have met its objectives and, accordingly, the IASB developed a new accounting model appropriate to insurance contracts (see paragraphs BCA22–BCA115).

Applying generally applicable Standards

BCA5 Insurance contracts are excluded from the scope of many current or proposed generic Standards that might otherwise apply to such contracts, including Standards on:

(a) revenue (see Exposure Draft *Revenue from Contracts with Customers*, published in November 2011);

(b) liabilities (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*); and

(c) financial instruments (see IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 9 *Financial Instruments*, IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosure* as well as the related Exposure Drafts proposing amendments to those Standards, such as the

Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9*, published in November 2012, and the Exposure Draft *Financial Instruments: Expected Credit Losses*, published in March 2013).

BCA6 Bringing insurance contracts within the scope of those Standards would mean that the entity would need to:

(a) identify service elements and investment elements within each premium that it receives.

(b) account for the service element as proposed in the 2011 Exposure Draft *Revenue from Contracts with Customers*. In addition, the entity would account for its liability for incurred claims in accordance with IAS 37.

(c) apply the financial instruments Standards to the investment element.

BCA7 Those consequences are discussed further in paragraphs BCA8–BCA15.

Revenue from contracts with customers

BCA8 If an entity applied the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers* to the service elements of the premium, it would:

(a) identify the separate performance obligations in the contract and allocate the transaction price across those performance obligations to measure each performance obligation.

(b) recognise an additional liability if a performance obligation is onerous.

(c) recognise revenue as it satisfies a performance obligation by providing insurance coverage. Typically, revenue would be recognised continuously over the coverage period.

(d) recognise a liability when a claim is incurred in accordance with IAS 37 (see paragraph BCA11).

BCA9 In the 2010 Exposure Draft, the IASB stated its view that, for some insurance contracts, it would be difficult to apply the proposals in the 2010 Exposure Draft *Revenue from Contracts with Customers* (which preceded the 2011 Exposure Draft *Revenue from Contracts with Customers*) and that the results of doing so would be of limited use to users of financial statements. In particular, the IASB was concerned that:

(a) for some types of contract, for example, stop-loss contracts, it would be difficult to determine the extent to which the entity had satisfied its performance obligations;

(b) when a contract provides embedded renewal options, it may be difficult to estimate at inception the stand-alone selling price for each of those options or find some reasonable approximation to each period of coverage; and

(c) when risk is likely to fluctuate both up and down, it is difficult to determine the extent to which the entity has satisfied its performance obligations.

BCA10 Nonetheless, in both this Exposure Draft and in the 2011 Exposure Draft *Revenue from Contracts with Customers*, the statement of financial position reports the

contract position, and the statement of profit or loss and other comprehensive income reports the amount of progress towards satisfying the performance obligations in the contract as follows:

(a) the 2011 Exposure Draft *Revenue from Contracts with Customers* establishes the amount of revenue that has been recognised in each period. The contract asset or contract liability at the start of the period is adjusted by the revenue recognised (performance obligations satisfied) during each period to determine the contract asset or contract liability at the end of the period; and

(b) this Exposure Draft proposes a measurement model to establish a current value measurement of the contract position at the end of each reporting period. As discussed in paragraphs BC73–BC79, the amount of revenue presented during the period can be measured by reference to the contract asset or contract liability at the beginning and the end of the period.

Accordingly, the IASB believes that the proposals in this Exposure Draft and the core principles of the 2011 Exposure Draft *Revenue from Contracts with Customers* are broadly consistent with each other.

Applying IAS 37 to the liability for incurred claims

BCA11 If an entity were to apply IAS 37 to the liability for incurred claims, it would recognise a liability as the insured events occur, and would measure that liability, both initially and subsequently, in accordance with IAS 37. That measurement would reflect current estimates of cash flows and a current market-based discount rate, which would in turn reflect the risks that are specific to the liability. This measurement would be broadly consistent with the proposals in this Exposure Draft for the liability for incurred claims.

Treating deposit elements as financial liabilities

BCA12 Some view some or all of the payments that arise in an insurance contract as, in substance, repayments of deposits. For example:

(a) a payment to the policyholder who paid the premium could be viewed as a repayment of a deposit by that policyholder.

(b) on a broader view, payments of the expected present value of insured losses could be viewed as a repayment to the community of policyholders of the part of their premiums that paid for the expected losses. In other words, policyholders are regarded as making a collective deposit that is later repaid in aggregate to policyholders. However, most policyholders receive no repayment and the amount 'returned' to any one policyholder typically differs from the amount 'deposited' by that policyholder.

(c) for a participating contract, an entity typically expects to return some of the premium paid by policyholders as benefit payments if insured events occur, or as a policyholder dividend if insured events do not occur. If benefit payments are higher the policyholder dividends will tend to be lower, although generally not by exactly the same amount.

(d) in the broadest sense, a deposit occurs if the policyholder pays premiums significantly before the coverage period to which those premiums relate. In many life insurance contracts, premiums are structured to include compensation in early years for risks that are not expected to arise until later years. The premiums in early years include deposits that are 'repaid' in the form of lower premiums when the higher risks occur in later years.

BCA13 If an entity accounted for the deposit elements of an insurance contract in the same way as for other financial liabilities, it would:

(a) recognise no revenue on the principal deposited;

(b) measure the deposit elements at fair value through profit or loss or at amortised cost, as applicable;

(c) measure the deposit elements so that the fair value of the deposit element would be no less than the amount that is payable on demand, discounted from the first date that the payment could be required (the 'deposit floor', which is discussed in paragraphs BCA43–BCA44);

(d) account separately for embedded options and guarantees as applicable for financial liabilities when so required by financial instruments Standards; and

(e) recognise, for deposit elements measured at fair value through profit or loss, the costs of originating contracts as an expense when incurred, with no corresponding gain at inception. In accordance with IFRS 9, if the deposit element is measured at amortised cost, incremental transaction costs relating to the deposit element would reduce the initial carrying amount of that liability.

BCA14 Applying generally applicable Standards for financial liabilities to insurance contracts would require entities to identify which deposits should be accounted for separately. As discussed in paragraph BCA16, that would be difficult and arbitrary and would increase complexity without providing useful information.

Summary

BCA15 Applying generally applicable IFRS would provide relevant information for users of financial statements and would be relatively easy to apply to insurance contracts for which there is no significant variability in outcomes and no significant investment components. However, it would be arbitrary, complex and produce information of limited relevance for other types of insurance contracts. In contrast, the model proposed in this Exposure Draft could be applied to all types of insurance contracts.

Bifurcation approach

BCA16 The IASB rejected a bifurcation approach that accounts separately for each component in an insurance contract. In the IASB's view, bifurcation approaches do not faithfully represent the package of rights and obligations in an insurance contract because:

(a) there is some inherent arbitrariness in deciding when a component should be bifurcated. This may result in the separation of one component but not of another component that generates similar exposures. For example, an entity may be required to bifurcate an embedded option or guarantee from a reinsurance asset, but would not be required to do so in the underlying direct insurance contracts issued by the entity. On the other hand, if significant interdependencies are present, the embedded option or guarantee is itself likely to meet the definition of an insurance contract. In that case, the embedded option or guarantee is unlikely to be bifurcated, even if similar risks arise from other embedded derivatives that do require bifurcation.

(b) bifurcation ignores interdependencies between components, with the result that the sum of the values of the components does not equal the value of the entire contract, even at contract inception. Moreover:

(i) after initial recognition, components may be measured on different measurement bases, causing even greater divergence between the sum of the carrying amounts of the components and the value of the contract as a whole.

(ii) applying different accounting requirements to components can be complex and may not generate relevant or understandable information for users of financial statements.

BCA17 Although the IASB has rejected a bifurcation approach, the proposed accounting model would require some components of an insurance contract to be separated, or unbundled, if the cash flows attributable to the individual component are distinct. In those cases, the problems created by interdependencies are less significant. The proposals for separating and measuring non-insurance components of an insurance contract are discussed in paragraphs BCA189–BCA208.

Predominant component approach

BCA18 The IASB rejected an approach in which the accounting for an insurance contract attempts to identify a predominant component. Although some insurance contracts are predominantly focused on one type of activity or have one predominant feature, many blend different activities in different proportions over time. A disadvantage of a predominant component approach is that it would create significantly inconsistent accounting treatments for contracts that are economically similar but that lie on different sides of an arbitrary dividing line.

Fair value approach

BCA19 The 2007 Discussion Paper had proposed that entities should measure insurance contracts using a current exit value measurement attribute, which is equivalent to fair value as defined in IFRS 13 *Fair Value Measurement*. This would be the amount that the entity would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. However, in the responses to the 2007 Discussion Paper, many suggested that the current exit value places too much emphasis on hypothetical transactions

that rarely happen. Although a price may be available at inception, it is not generally available later in the contract because entities typically would not sell new contracts with the same remaining exposure. This Exposure Draft proposes to measure insurance contracts in a way that reflects the fact that entities generally fulfil insurance contracts directly over time by payments of benefits and claims to policyholders, rather than by transferring the contracts to a third party.

Selecting an existing model

BCA20 Some respondents to the Discussion Paper, mainly from the US, suggested that the IASB should develop an approach based on existing US GAAP for insurance contracts. The IASB rejected this suggestion because such an approach would be based on the type of entity issuing the contract and on numerous standards developed at different times. Furthermore, although US GAAP is widely used, it has areas for improvement that are difficult to address in isolation. Some of those areas for improvement were described in the FASB's Discussion Paper *Preliminary Views on Insurance Contracts*, published in September 2010. That Discussion Paper also identified how the FASB intended to improve US GAAP. The IASB's proposals address those areas for improvement, as follows:

Current US GAAP[(a)]	Desired Improvement	IASB approach
Insurance entity orientation— requirements do not apply to contracts issued by noninsurance entities even if contracts are economically and functionally equivalent to insurance contracts.	Regardless of the type of entity issuing the contracts, contracts that transfer significant insurance risk and contain identical or similar economic characteristics should be accounted for in a similar manner.	This Exposure Draft would apply to insurance contracts issued by all entities. However, this Exposure Draft would also apply to: • investment contracts with a discretionary participation feature (known in the IASB's 2010 Exposure Draft as 'financial instruments with discretionary participation features'), but only if issued by entities that issue insurance contracts. • financial guarantee contracts, but only if issued by entities that issue insurance contracts.

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Current US GAAP[(a)]	Desired Improvement	IASB approach
Definition of an insurance contract—insurance contracts under US GAAP are those written by insurance entities that indemnify the policyholder against loss or liability. A notion based on indemnification generally limits the claim to the amount of the loss.	A uniform definition of an insurance contract should be developed. That definition should use *compensation* rather than *indemnification* to define the insurance contract benefit. Compensation is a broader notion than indemnification and would be less likely to limit the claim payment to the loss.	The IASB proposes to define an insurance contract as a "contract under which one party (the issuer) 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." The IASB proposes application guidance that "insurance risk is significant if, and only if, an insured event could cause the issuer to pay amounts that are significant in any scenario, excluding scenarios that have no commercial substance (ie no discernible effect on the economics of the transaction)."

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Current US GAAP[(a)]	Desired Improvement	IASB approach
Deferral of acquisition costs—Costs that vary with and are primarily related to the acquisition of insurance contracts may be deferred and subsequently amortized. Diversity in practice exists with respect to which costs may be deferred. [In September 2010], the Emerging Issues Task Force (EITF) reached a final consensus to narrow the types of costs that may be capitalized.[(b)] Specifically, the new model aligns the recognition of deferred acquisition costs with the accounting for loan origination costs in Subtopic 310–20, *Receivables—Nonrefundable Fees and Other Costs*®.	If targeted improvements are made to current US GAAP (rather than amended by the proposed model being discussed jointly with the IASB), some have said the EITF final consensus may adequately improve the accounting model for acquisition costs relating to insurance contracts. Others have said that all acquisition costs should be expensed as incurred to be generally consistent with the accounting guidance for costs to acquire contracts that generate revenue in numerous other Topics within US GAAP.	The IASB: • proposes that the insurance contract liability should be measured as the sum of the fulfilment cash flows, including any acquisition costs still to be paid, and the contractual service margin. • recognises acquisition cost expense in profit or loss in a similar way as would have been achieved using a deferred acquisition cost model.

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Current US GAAP[(a)]	Desired Improvement	IASB approach
Assumptions for traditional long-duration contracts —the assumptions used to calculate long-duration contract policyholder benefits are locked in (that is, they are not updated unless the existing contract liabilities, together with the present value of future gross premiums, become insufficient to cover the present value of future benefits to be paid to or on behalf of the policyholders and to recover unamortized acquisition costs).	To reflect the risks and uncertainties inherent in long-duration contracts, some or all assumptions should be reevaluated and updated at each reporting period to reflect all available information.	The IASB proposes that all assumptions, including those about risk, should be updated at each reporting period to reflect all of the available information.
Discount rate for traditional long-duration contracts—Assumptions for discounting of liabilities on traditional long-duration contracts are based on the estimated investment yields (net of related investment expenses) expected at the contract issue date.	The discount rates used to measure the contract liabilities should be based on current rates that reflect the characteristics of the liabilities rather than the invested assets related to those liabilities.	The IASB proposes that the discount rates used to measure the contract liabilities should be based on current rates that reflect the characteristics of the liabilities rather than the invested assets related to those liabilities.

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Current US GAAP[(a)]	Desired Improvement	IASB approach
Lack of discounting of liabilities for short duration contracts—Most liabilities for short duration contracts are not discounted even though the expected claims settlement (payment) period may extend for many years on some contracts.	Measurement of all contract liabilities should be discounted at current rates to reflect the time value of money, if material.	The IASB proposes that all insurance contract liabilities should be discounted at current rates to reflect the time value of money, but specifies some circumstances in which the effect of discounting is deemed to be insignificant.

(a) The 'Current US GAAP' and 'Desired improvement' columns have been extracted from the FASB's 2010 Discussion Paper *Preliminary Views on Insurance Contracts*.
(b) In October 2010, the FASB issued *Accounting Standards Update 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, a consensus of the FASB Emerging Issues Task Force (ASU 2010–26), which endorsed and codified that decision.

BCA21 The IASB also decided that it would not be appropriate to account for insurance contracts using other existing insurance accounting models because many such models:

(a) do not use current estimates of all cash flows.

(b) do not require explicit measures of risk, which is the essence of insurance.

(c) fail to reflect the time value or intrinsic value of some or all embedded options and guarantees, or else they measure time value or intrinsic value in a way that is inconsistent with current market prices.

(d) present an entity's financial performance, particularly for life insurance, in a manner that is difficult for users of financial statements to understand.

The measurement model proposed in this Exposure Draft

BCA22 The IASB concluded that none of the approaches described in paragraphs BCA5–BCA21 is suitable for insurance contracts and it therefore developed an accounting model specifically for insurance contracts. That model proposes that an entity should measure an insurance contract in a way that provides a current depiction of the insurance contract. It has the following features:

(a) it combines the service and financial elements of a contract and reports these elements as a package of cash inflows and cash outflows.

(b) it would require an entity to identify and measure directly the contractual rights and obligations arising from insurance contracts. Accordingly, it provides information about how changes in the measure of the insurance contract affect the entity's obligations.

(c) it supplements information obtained from the measurement of the insurance contract with information about revenue and expense that is consistent with the measurement of the obligation to provide coverage.

(d) it measures insurance contracts in a way that reflects the fact that entities typically expect to fulfil insurance contracts directly over time by payments of benefits and claims to policyholders, rather than by transferring the contracts to a third party. Consequently, this Exposure Draft proposes that an entity should not reflect the risk of non-performance by the issuer and the recognition of a gain at inception is prohibited.

BCA23 The model proposed in this Exposure Draft would include two components in the measurement of an insurance contract:

(a) the risk-adjusted expected present value of the cash flows that will arise as a result of the entity fulfilling the contract (known as the 'fulfilment cash flows'); and

(b) a contractual service margin that reports profitability of the contract over the coverage period.

BCA24 The sections below discuss those components of the measurement of an insurance contract, in particular:

(a) how an entity estimates the expected value of cash flows (see paragraphs BCA25–BCA35);

(b) which cash flows should be included in the expected value of cash flows (see paragraphs BCA36–BCA63);

(c) how the cash flows are adjusted to reflect the time value of money (see paragraphs BCA64–BCA88);

(d) how the cash flows are adjusted to depict the effects of risk and uncertainty (see paragraphs BCA89–BCA104); and

(e) how the contractual service margin is measured and recognised in profit or loss (see paragraphs BCA105–BCA115).

How an entity estimates the expected present value of cash flows (paragraphs 22 and B40–B61)

BCA25 This section discusses how an entity estimates the expected value of cash flows, including:

(a) explicit, current estimates at the reporting date (see paragraphs BCA26–BCA28);

(b) explicit estimates of cash flows that do not contradict available market information (see paragraphs BCA29–BCA30); and

(c) unbiased use of all of the available information (see paragraphs BCA31–BCA35).

Explicit, current estimates at the reporting date (paragraphs B55–B61)

BCA26 The IASB proposes that estimates of cash flows should be based on current information, updated at the end of every reporting period. Existing insurance measurement models often require entities to make estimates at inception and use the same estimates throughout the life of the contract, ignoring information that becomes available later in the life of the contract. However, the IASB believes that using current estimates:

(a) gives a more faithful representation of the entity's contractual obligations and rights, and conveys more useful information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Because of the uncertainty associated with insurance liabilities and the long duration of many insurance contracts, current information about the amount, timing and uncertainty of cash flows is particularly relevant for users of financial statements.

(b) incorporates all of the available information in the measurement, thus avoiding the need for a separate test to ensure that the liability is not understated (sometimes known as a 'liability adequacy test'). Any liability adequacy test is likely to involve some elements that are arbitrary. For example, such a test implicitly recognises some favourable changes in estimates if they happen to occur at the same time as other changes that are adverse. Similarly, such a test does not reveal adverse changes if those changes are absorbed by large implicit margins that existed at inception.

(c) is broadly consistent with other Standards for provisions (IAS 37) and financial liabilities (IFRS 9). That is, for liabilities with characteristics similar to insurance contracts liabilities, both IAS 37 and IFRS 9 would require measurements that are based on current estimates of future cash flows.

BCA27 The IASB also believes that explicit estimates of cash flows, which require an entity to consider actively whether circumstances have changed, result in a more faithful representation of the entity's obligations towards policyholders. The resulting information is more relevant to users of financial statements, more understandable, more comparable with information produced by applying IFRS to other liabilities and has a reduced risk that the entity had not identified some changes in circumstances.

BCA28 The IASB considered how its principles of using current estimates of expected cash flows interact with the requirements of IAS 10 *Events after the Reporting Period*. This Exposure Draft measures the insurance contract using estimates of the expected cash flows made at the end of the reporting period, even when the uncertainties affecting the reliability of those estimates are sometimes resolved by events that occur after the reporting period but before the financial statements are issued or are available to be issued. The IASB concluded that, in such cases, the requirements of IAS 10 apply. Thus, an insured event that was

impending at the end of the reporting period does not constitute evidence of a condition that existed at the end of the reporting period when the event either occurs or does not occur after that date.

Estimates that do not contradict available market information (paragraphs B43–B54)

BCA29 The IASB believes that measurements are more relevant and reliable if they are as consistent as possible with observed market prices, because such measurements:

(a) involve less subjectivity than measurements that use the entity's own estimates;

(b) reflect all evidence that is available to market participants; and

(c) are developed using a common and publicly accessible benchmark that users of financial statements can understand more easily than information developed using a private, internal benchmark.

BCA30 This view has the following consequences:

(a) an entity would use observable current market variables, such as interest rates, as direct inputs without adjustment; and

(b) in principle, consistency with observed market prices implies that estimates of cash flows should be consistent with the estimates that other market participants would make. However, many variables cannot be observed in, or derived directly from, market prices. Examples of such variables are mortality and the frequency and severity of insurance claims. When developing estimates of these variables, an entity would need to consider all of the available data, external and internal. However, the estimates should not contradict current market variables. For example, estimated probabilities for inflation scenarios should not contradict probabilities implied by market interest rates.

Unbiased use of all of the available information (paragraphs B40–B42)

BCA31 Because insurance contracts transfer risk, the cash flows generated by an insurance contract are uncertain. In other words, several outcomes are possible. Some argue that a measurement of an insurance contract should use a single estimate of the cash flows, for example the most likely outcome or an outcome that is likely to prove 'sufficient' at some implicit or explicit level of confidence. However, a measurement of an insurance contract is most useful if it captures information about the full range of possible outcomes and their probabilities.

BCA32 Consequently, the IASB proposes that an insurance contract should start with an estimate of the expected present value of the cash flows generated by the contract. The expected present value is the probability-weighted average of the present value of the possible cash flows. The IASB proposes that, when an entity determines that amount, estimates of the probabilities associated with each cash flow scenario should be neutral. In other words, they should not be biased with the intention of attaining a predetermined result or inducing particular behaviour. Neutrality is important because biased financial reporting

information cannot faithfully represent economic phenomena. Among other things, neutrality requires that estimates of cash flows and the associated probabilities should be neither conservative nor optimistic.

BCA33 In principle, determining an expected present value involves the following steps, although practical shortcuts may be available to implement those steps with an acceptable degree of accuracy:

(a) identifying each possible scenario;

(b) measuring the present value of the cash flows in that scenario—paragraphs BCA65–BCA70 and BCA74–BCA88 discuss the discount rate; and

(c) making an unbiased estimate of the probability of that scenario occurring.

Depending on the circumstances, an entity might develop these estimates by identifying individual scenarios, developing a formula that reflects the entity's estimate of the shape and width of the probability distribution or using random simulation.

BCA34 An expected present value is not a forecast that a particular outcome will occur. Consequently, differences between the ultimate outcome and the previous estimate of expected value are not 'errors' or 'failures'. The expected value is a summary that incorporates all foreseeable outcomes. When one of those outcomes occurs, that outcome does not invalidate the previous estimate of the expected value.

BCA35 Many insurance liabilities contain significant embedded options and guarantees. Most accounting models have, until recently, attributed no value to embedded options or guarantees that have no 'intrinsic value' because they are currently out of the money. However, such embedded options and guarantees also have a 'time value' because they could be in the money at expiry. Because the expected present value approach considers all possible outcomes, it incorporates both the intrinsic value and time value of embedded options and guarantees. It therefore represents their economic substance more faithfully.

The cash flows used to measure the insurance contract liability (paragraphs 23–24 and B62–B67)

BCA36 This section discusses which cash flows should be included in the expected value of cash flows, including:

(a) cash flows that arise from future premiums (see paragraphs BCA37–BCA44);

(b) acquisition costs (see paragraphs BCA45–BCA57); and

(c) cash flows that are expected to vary directly with returns on underlying items (see paragraphs BCA58–BCA63).

Cash flows that arise from future premiums (paragraphs B62–B65)

BCA37 The IASB proposes that the measurement of an insurance contract should include all the cash flows that are expected to result from the contract, taking

into account estimates of policyholder behaviour. Thus, to identify the future cash flows that will arise as the entity fulfils its obligations, it is necessary to distinguish whether future premiums, and the resulting benefits and claims, arise from either of the following:

(a) the existing insurance contract. If so, those future premiums, and the resulting benefits and claims, are included in the measurement of the insurance contract.

(b) a future insurance contract. If so, those future premiums, and the resulting benefits and claims, are not included in the measurement of the existing insurance contract.

In other words, it is necessary to draw a contract boundary.

BCA38 The essence of a contract is that it binds one or both of the parties. If both parties are bound equally, the boundaries of the contract are generally clear. Similarly, if neither party is bound, it is clear that no genuine contract exists. Thus:

(a) the point at which the entity is no longer required to provide coverage and the policyholder has no right of renewal is one point on the boundary of the existing contract. Beyond that point, neither party is bound.

(b) at the point at which the contract confers on the entity the right or the practical ability to reassess the risk presented by a policyholder and, as a result, can set a price that fully reflects that risk, the entity is no longer bound by the existing contract. Thus, any cash flows arising beyond that point occur beyond the boundaries of the existing contract and relate to a future contract, not to the existing contract.

(c) if an entity has the right or the practical ability to reassess the risk presented by a policyholder, but does not have the right to set a price that fully reflects the reassessed risk, the contract still binds the entity. Thus, that point would lie within the boundary of the existing contract, unless the restriction on the entity's ability to reprice the contract is so minimal that it is expected to have no commercial substance (ie the restriction has no discernible effect on the economics of the transaction). In the IASB's view, if a restriction has no commercial substance, it does not bind the entity.

BCA39 However, it may be more difficult to decide where the boundaries lie if the contract binds one party more tightly than the other. For example:

(a) an entity may price a contract so that the premiums charged in early periods subsidise the premiums charged in later periods, even if the contract states that each premium relates to an equivalent period of coverage. This would be the case if the contract charges level premiums and the risks covered by the contract increase with time. In the IASB's view, the premiums charged in later periods would fall within the boundary of the contract because, after the first period of coverage, the policyholder has obtained something of value, namely the ability to continue coverage at a level price despite increasing risk.

(b) an insurance contract might bind the entity but not the policyholder by requiring the entity to continue to accept premiums and provide coverage but permitting the policyholder to stop paying premiums, although possibly for a penalty.

(c) an insurance contract may permit an entity to reprice the contract on the basis of general market experience (for example, mortality experience) but without permitting the entity to reassess the individual policyholder's risk profile (for example, the policyholder's health). In this case, the insurance contract binds the entity by requiring it to provide the policyholder with something of value: continuing insurance coverage without the need to undergo re-underwriting. Although the terms of the contract are such that the policyholder has benefit in renewing the contract, and thus the entity expects that renewals will occur, the contract does not bind the policyholder to renew the contract. The IASB concluded that ignoring the entity's expectation of renewals would not reflect the entity's economic circumstances created by the contract. Consequently, in developing the 2010 Exposure Draft, the IASB concluded that if the entity can reprice an existing contract for general but not individual-specific changes in policyholders' risk profiles, the cash flows resulting from the renewals that are repriced in this way lie within the boundaries of the existing contract.

BCA40 Many respondents to the 2010 Exposure Draft suggested that the proposals included, within the boundary of some contracts, some cash flows for which the entity was not bound. Those respondents noted that even when an entity is prevented from repricing an existing contract using an individual policyholder's risk assessment, the entity may nonetheless be able to reprice the portfolio to which the contract belongs with the result that the price charged for the portfolio as a whole fully reflects the risk of the portfolio. As a result, they believe that the entity is no longer bound by the existing portfolio of contracts and that any cash flows that arise beyond that point should be considered to be beyond the boundaries of the existing contract. To the extent that an entity would not be able to charge a price that fully reflects the risks of the portfolio as a whole, it would be bound by the existing contract, for example, if the contract or regulation were to limit the entity's ability to set a price that fully reflects the risk in the accounting period. The IASB was persuaded by this view and proposes to modify the contract boundary so that such cash flows are considered to be outside the contract boundary.

BCA41 This Exposure Draft captures the above conclusions by proposing that premiums and related cash flows are outside the contract boundary when the entity:

(a) is no longer required to provide coverage;

(b) has the right or the practical ability to reassess the risk of the particular policyholder and can set a price that fully reflects that risk; or

(c) has the right or the practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price that fully reflects the risk of that portfolio, provided that the pricing of the premiums for coverage up to that date does not take into account the risks relating to future periods.

BCA42 Because the entity updates the measure of the insurance contract or portfolio of contracts in each reporting period, the assessment of the contract boundary is made in each reporting period. For example, in one reporting period an entity may decide that a renewal premium for a portfolio of contracts is outside the contract boundary because the restriction on the entity's ability to reprice the contract has no commercial substance. However, if the portfolio of contracts becomes onerous and, as a result, the same restrictions on the entity's ability to reprice the portfolio become relevant, the entity may conclude that future renewal premiums for that portfolio of contracts are within the boundary of the contract.

Deposit floor

BCA43 The issue of contract boundaries is related to another question, namely, whether an entity should apply a deposit floor when measuring insurance contracts. The 'deposit floor' is a term used to describe the following requirement in paragraph 47 of IFRS 13:

> The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

BCA44 If a deposit floor were to be applied when measuring insurance contracts, the resulting measurement would ignore all scenarios other than those involving the exercise of policyholder options in the way that is least favourable to the entity. Such a requirement would contradict the fundamental principle that an entity should incorporate, in the measurement of an insurance contract, future cash flows on a probability-weighted basis. For some contracts, it would also move the contract boundary to the reporting date. Consequently, this Exposure Draft does not propose the application of a deposit floor when measuring insurance contracts. However, it is proposed in paragraph 93(b) that entities should disclose the amount payable on demand in a way that highlights the relationship between such amounts and the carrying amount of the related contracts.

Acquisition costs (paragraph B66(c))

BCA45 Entities often incur significant costs to sell, underwrite and initiate a new insurance contract. These costs are commonly referred to as 'acquisition costs'. An insurance contract is generally priced to recover those costs through premiums and through surrender charges.

Measurement approach

BCA46 The measurement approach proposed in this Exposure Draft represents a change from many existing accounting models, which measure insurance liabilities initially at the amount of the premium received, with deferral of acquisition

costs. Such models treat acquisition costs as a representation of the cost of a recognisable asset, which, depending on the model, might be described as a contract asset or a customer relationship intangible asset. In the IASB's view, such an asset either does not exist, if the entity recovers acquisition costs from premiums already received, or relates to future cash flows that should be included in the measurement of the contract. Furthermore, in the IASB's view, an entity typically charges the policyholder a price that the entity regards as sufficient to compensate it for two things: undertaking the obligation to pay for insured losses and the cost of originating the contracts. Thus, a faithful representation of the remaining obligation to pay for incurred losses should not include the part of the premium that paid for the cost of originating the contracts.

BCA47 Consequently, the IASB has previously concluded in its 2007 Discussion Paper that an entity should recognise acquisition costs as an expense, and should recognise an amount of revenue equal to the portion of the premium that relates to recovering its acquisition costs. The 2010 Exposure Draft achieved that outcome differently by proposing that the contract cash outflows should include the incremental acquisition costs incurred by the entity. That reduced the contractual service margin at initial recognition of the contract and had the advantage that the cash flows relating to acquisition costs would be treated in the same way as other cash flows incurred in fulfilling contracts.

BCA48 The 2010 Exposure Draft proposed a summarised-margin approach for the presentation of the statement of profit or loss and other comprehensive income that would not present insurance contract revenue in the statement of profit or loss and other comprehensive income. In contrast, as discussed in paragraphs BC73–BC100, this Exposure Draft proposes that entities should report insurance contract revenue in the statement of profit or loss and other comprehensive income. Because insurance contract revenue is recognised in the same pattern as changes in the liability for the remaining coverage, this would mean that some of the insurance contract revenue would be recognised when the acquisition costs are paid, often at the beginning of the coverage period.

BCA49 The IASB was concerned that recognising insurance contract revenue at the beginning of the coverage period would be inconsistent with the principles in its 2011 Exposure Draft *Revenue from Contracts with Customers* because, at the beginning of the coverage period, the entity has not satisfied any of the obligations to the policyholder under the contract. That Exposure Draft instead proposed that an entity should recognise as revenue the consideration received from the customer as it satisfies its performance obligations under the contract. Accordingly, the IASB decided that the premium related to acquisition costs should not be recognised when the acquisition costs are incurred, but should be separately identified and recognised over the coverage period as insurance contract revenue in the pattern of services provided by the contract. The acquisition cost expense would also be recognised as an expense over the same period in the same pattern.

BCA50 The proposal to recognise acquisition costs as an expense over the coverage period does not mean that those costs are deferred as if they were the cost of an asset or an explicit or implicit reduction in the carrying amount of the

insurance contract liabilities. At all times, the insurance contract liability is measured as the sum of the fulfilment cash flows, including any expected acquisition costs, and the contractual service margin. Because the contractual service margin cannot be less than zero, there is no need to test separately whether the entity will recover the acquisition costs that have been incurred but have not yet been recognised as an expense. The measurement model captures any lack of recoverability automatically by remeasuring the fulfilment cash flows.

Acquisition costs included in measurement

BCA51 The 2010 Exposure Draft proposed that only acquisition costs that are incremental at a contract level should be included in the measurement of an insurance contract. This is because those costs can be clearly identified as relating specifically to the contract. Including broader costs would result in more subjectivity.

BCA52 However, many respondents to the 2010 Exposure Draft stated that this approach would be inconsistent with the portfolio assessment of all the other cash flows that are used to measure the insurance contract in general.

BCA53 Because of the responses, the IASB re-evaluated how it had weighted the arguments in the 2010 Exposure Draft. In particular, the IASB noted that:

(a) the proposals in the 2010 Exposure Draft would mean that entities would report different liabilities and expenses depending on the way in which they structured their acquisition activities. For example, there would be different liabilities reported if the entity had an internal sales department rather than outsourcing sales to external agents. In the IASB's view, differences in the structure of acquisition activities would not necessarily reflect economic differences between entities.

(b) an entity typically prices an insurance contract to recover not only incremental costs, but also other direct costs and a proportion of indirect costs that are incurred in originating insurance contracts—such as underwriting, medical and inspection, and issuing the policy. These costs are measured and managed at the portfolio level, rather than at the individual contract level. Accordingly, including acquisition costs in the contractual cash flows of the insurance contract that are incremental at the portfolio level would reflect the expected value of the cash flows associated with the insurance contract and be consistent with the unit of account used for measurement.

BCA54 In accounting periods beginning after 15 December 2011, and interim periods within those accounting periods, the FASB's *Accounting Standards Update* 2010–26 became effective. Update 2010–26 restricted the acquisition costs that could be capitalised as deferred acquisition costs under US GAAP, including a restriction that such acquisition costs should include only those related directly to the successful acquisition of new or renewed insurance contracts.

BCA55 The IASB considered whether a similar restriction should apply to the cash flows arising from acquisition costs that are used to measure the insurance contract. However, excluding some acquisition costs that have been incurred to acquire a portfolio would:

(a) result in an understatement of the fulfilment cash flows and an overstatement of the contractual service margin;

(b) not reflect the fact that an entity must incur such costs in originating the portfolio of contracts that it recognises; and

(c) result in different liabilities and expenses depending on how an entity structures its acquisition activities, as described in paragraph BCA53.

BCA56 The IASB also noted that a distinction between successful and unsuccessful efforts could be appropriate in a model, such as existing US GAAP, that recognises deferred acquisition costs as the cost of a separately recognised asset. In such models, the issue arises as to whether the costs of unsuccessful efforts could be considered recoverable. Contracts that were not issued do not generate cash flows from which the entity can recover costs. However, as described in paragraph BCA50, the measurement model proposed in this Exposure Draft would automatically recognise as an immediate expense any acquisition costs that cannot be recovered from the cash flows of the portfolio of contracts, because such costs would reduce the contractual service margin below zero and must therefore be recognised as an expense.

BCA57 The FASB has tentatively decided that entities should present acquisition costs incurred as a reduction of the margin rather than as part of the fulfilment cash flows.[6] The margin would be recognised as income over the coverage and settlement periods of the contract. This Exposure Draft would achieve a similar outcome, but with the following differences:

(a) different disclosures and disaggregation in the roll-forwards and statement of financial position: the FASB's proposals would exclude cash flows arising from acquisition costs to be incurred in the future from being presented as part of the fulfilment cash flows in the statement of financial position.

(b) different recognition period of the effects of acquisition costs on revenue and expenses: because of differences in the IASB's and the FASB's proposals about the period over which the contractual service margin would be recognised, the IASB's proposals recognise the acquisition costs over the coverage period, whereas the FASB's proposals would recognise the acquisition costs over the coverage and settlement periods. The recognition in profit or loss of the contractual service margin is described in paragraphs BCA109–BCA112.

6 In the FASB's 2010 Discussion Paper *Preliminary Views on Insurance Contracts*, the 'margin' was referred to as the 'composite margin'.

Cash flows that are expected to vary with returns on underlying items (paragraphs 33–34 and 66)

BCA58 Some insurance contracts give policyholders the right to share in the returns on specified underlying items. In some cases, the contract requires that the entity must pass on a specified proportion of the cumulative return on underlying items to the pool of policyholders that exists when the payments are made, even though the payments in any given accounting period may be subject to the discretion of the issuer, either in their timing or in their amount. Such discretion is usually subject to some contractual constraint, including related legal and regulatory constraints and market competition.

BCA59 This Exposure Draft proposes that the measurement of an insurance contract should include an unbiased estimate of the cash outflows from the contract that are expected to vary with returns on underlying items. This would be regardless of whether such cash outflows are paid to satisfy a legal or constructive obligation arising from the contract that exists at the reporting date, or whether they are paid to current or future policyholders. The IASB's proposes this because:

(a) including all the cash flows that arise from insurance contracts is consistent with the IASB's principle that the measurement of an insurance contract should treat all cash flows that arise from the contract in the same way. It is also consistent with that principle to treat all cash flows specified by the contractual terms of the contract in the same way, regardless of the counterparty.

(b) it can be difficult to determine whether an entity is making payments because it believes it is obliged to do so, rather than for some other reason that does not justify the recognition of a standalone liability. Those reasons could be to maintain the entity's competitive position or because the entity believes it is under some moral pressure. Thus, it could be difficult to make a reasonable estimate of what level of distribution would ultimately be enforceable in the unlikely event that an entity asserts that its discretion to pay or withhold amounts to policyholders is unfettered.

(c) for many contracts for which the payments to policyholders depend on underlying items, the premiums are generally set in the expectation, shared by both parties, that the entity will make payments unless performance is ultimately considerably worse than expected. Those payments can be viewed as a return of excess premiums. Consequently, it is appropriate to include those payments in the measurement on the same expected value basis as the premiums.

(d) the payments that arise from the performance of underlying items are inversely related to the payments that do not depend on underlying items for the portfolio as a whole. In some scenarios, the payments that do not depend on underlying items will be high and the payments that depend on underlying items will be low, whereas in other scenarios the inverse will be the case. If the measurement excludes some of the cash flows that would occur in some scenarios, the resulting measurement

will be less consistent and understandable and will provide less relevant information for users of financial statements.

(e) even if it were possible to make a reasonable estimate of non-discretionary cash flows, investors would not benefit from knowing how much might be enforceable in the highly unlikely event that an entity tried to avoid paying amounts to policyholders when it expects that such benefits would be paid. That amount provides no information about the amount, timing and uncertainty of future cash flows. On the other hand, investors would want to know:

(i) how much of the cash flows will not be available to investors because the entity expects to pay them to policyholders. The proposed model conveys that information by including those cash flows in the measurement of the liability.

(ii) how much of the risk in the contracts is borne by the policyholders through the participation mechanism and how much by the investors themselves. This information can be conveyed by the required disclosures about risk.

BCA60 Some have expressed concerns that the proposed treatment of payments that are subject to the entity's discretion means that the IASB does not attach enough importance to the definition of a liability in its *Conceptual Framework*. That is not the case. Those benefits arise from one component of a contract that, when considered as a whole, clearly meets the *Conceptual Framework's* definition of a liability. It may be possible to ascertain whether every single piece of that component, if viewed in isolation, meets the definition of a liability. However, in the IASB's view, doing so would not generate more relevant information for users of financial statements, would not provide a more faithful representation of the entity's financial position and financial performance and would impose unjustifiable costs.

BCA61 Some have expressed concerns that the proposed treatment of payments that depend on underlying items and that are subject to the issuer's discretion could lead to the conclusion that preference shares should be classified as liabilities, or might lead to structuring opportunities if entities embed preference shares in insurance contracts. However, there are some significant differences between preference shares and insurance contracts that promise returns to policyholders subject to the issuer's discretion:

(a) the payments to policyholders in an insurance contract are an integral component of a single instrument and are inversely related to the fixed benefits for the portfolio as a whole. If one is high, the other tends to be low. There is no equivalent inverse relationship for preference shares.

(b) preference shares generally confer a right to share in distributions on liquidation and to receive dividends, if declared, during the life of the entity. In contrast, although insurance contracts may confer a right to share in any distributions, this right expires when the contract matures.

BCA62 Some insurance contracts that specify payments to policyholders based on underlying items are issued by mutual entities, while others are issued by

investor-owned entities. The IASB has identified no reason to adopt different treatments for these contracts on the basis of the legal form of the issuer. This means that, if the contract provides policyholders with the right to participate in the whole of any surplus of the issuing entity, there would be no equity remaining and no profit reported in any accounting period. In the FASB's approach, a mutual entity treats as equity an amount of surplus that the entity does not have the obligation or intention to pay out in fulfilling the insurance contract obligations. The FASB believes that this approach is consistent with its treatment of the cash flows resulting from any other entity's discretionary participation features (that is, to include only cash outflows that an entity will incur to directly fulfil its obligation to the policyholders). In addition, the FASB believes that presenting the amounts the entity is obligated and intends to pay its policyholders as a liability, and this 'notional' surplus that it is not obligated and does not intend to pay to policyholders as equity, would provide more useful information to users of the financial statements of mutual entities and would be more comparable to other entities that issue similar insurance contracts.

BCA63 Some have asked whether the IASB intends to provide specific guidance on amounts that have accumulated over many decades in participating funds and whose 'ownership' may not be attributable definitively between shareholders and policyholders. The IASB does not propose such guidance. In principle, the proposals would require an entity to estimate the cash flows in each scenario. If that requires difficult judgements or gives rise to unusual levels of uncertainty, an entity would consider those matters in deciding what disclosures it must provide to satisfy the proposed disclosure objective.

Time value of money (paragraphs 25–26, 30(a), 40 and B69–B75)

BCA64 This section discusses:

(a) whether the measurement of all insurance contracts should reflect the time value of money (see paragraphs BCA65–BCA70);

(b) accretion of interest (see paragraphs BCA71–BCA73);

(c) current, market-consistent estimates of the time value of money (see paragraph BCA74);

(d) reflecting liquidity factors in the discount rate for an insurance contract (see paragraphs BCA75–BCA82);

(e) disclosure of the yield curve (see paragraph BCA83); and

(f) reflecting dependence on underlying items in the discount rate (see paragraphs BCA84–BCA88).

Time value of money for all insurance contracts

BCA65 Entities and users of financial statements are not indifferent to the timing of cash flows. An amount payable tomorrow is not equivalent to the same amount payable in ten years' time. In other words, money has a time value. The IASB

proposes that the measurement of all insurance contracts should reflect the time value of money, because that is a more faithful representation of the entity's financial position.

BCA66 Some respondents to the 2010 Exposure Draft and the 2007 Discussion Paper suggested that entities should not discount their non-life (property and casualty) insurance contract liabilities. In their opinion, measuring non-life insurance contracts at a discounted amount would produce information that is less reliable, because non-life insurance contracts are more uncertain than life insurance contracts with respect to:

(a) whether the insured event will occur, whereas the insured event in a life insurance contract is certain to occur unless the policy lapses;

(b) the amount of the future payment that would be required if an insured event occurs, whereas the amount of the future payment obligation is generally specified in, or readily determinable from, a life insurance contract; and

(c) the timing of any future payments required when the insured event occurs, whereas the timing of future payments in a life insurance contract is typically more predictable.

BCA67 These uncertainties mean that the cash flows for many non-life insurance contracts are less predictable than for many life insurance contracts. Some commentators believe that estimating the timing of payments and calculating a discount rate would introduce additional subjectivity into the measurement of insurance contracts, and that this could reduce comparability and permit earnings management. Furthermore, they believe that the benefits of presenting a discounted measure of non-life insurance contracts may not justify the costs to prepare that measure. They believe that the timing of cash flows and, therefore, of interest is an essential component of the pricing and profitability of life insurance contracts, but is less relevant for non-life insurance contracts for which they view underwriting results as the most critical component of the pricing and profitability.

BCA68 These arguments did not persuade the IASB. As noted in paragraph BCA65, entities and users of financial statements are not indifferent to the timing of cash flows and, therefore, measuring an insurance contract using undiscounted cash flows would not faithfully represent the entity's financial position and would be less relevant to users of financial statements. The IASB also concluded that discount rates and the amount and timing of future cash flows can generally be estimated 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 measurements within a reasonably narrow range and results in more relevant information for users of financial statements. Furthermore, many entities have experience in discounting, both to support investment decisions and to measure items for which other Standards require discounting, such as employee benefit obligations and long-term non-financial liabilities.

BCA69 Some commentators suggested that measuring non-life insurance contracts at undiscounted amounts that ignore future inflation could provide a reasonable

approximation of the value of the liability, especially for short-tail liabilities, and at less cost and with less complexity than explicit discounting. However, this approach of implicitly discounting the liability makes the unrealistic assumption that two variables (claim inflation and time value) will more or less offset each other in every case. As this is unlikely, the IASB concluded that financial reporting will be improved if entities estimate those effects separately.

BCA70 As discussed in paragraph BCA123, for contracts to which the entity applies the simpler premium-allocation approach, the IASB proposes that an entity need not reflect the effects of the time value of money in some cases in which those effects would be deemed to be insignificant.

Accretion of interest (paragraph 30(a))

BCA71 This Exposure Draft proposes that an entity should accrete interest on the contractual service margin. In the IASB's view:

(a) at initial recognition, the contractual service margin can be viewed as an allocation of part of the transaction price, which comprises the consideration paid to, or payable by, the policyholder. Accreting interest on the contractual service margin is consistent with the proposal in the 2011 Exposure Draft *Revenue from Contracts with Customers*, which would require an entity to adjust the promised consideration to reflect the time value of money if the contract has a significant financing component. As a result of that adjustment, the transaction price would reflect the amount that the customer would pay in cash for the promised good or service at the time that they receive the good or service. Consequently, an entity would recognise revenue at an amount that corresponds to the cash selling price of the good or service, with the effects of the financing presented separately from revenue (as interest expense or interest income).

(b) the contractual service margin is one part of an overall measure of the insurance contract, and every other component of that measure reflects the time value of money, leading to subsequent accretion of interest. The accretion of interest on the contractual service margin is consistent with that fact.

BCA72 Because the contractual service margin is measured at contract inception, the IASB proposes that the interest rate used to accrete interest on the margin would be locked-in at contract inception and not adjusted subsequently. Furthermore, the discount rate applied to cash flows that are included in the measurement of the liability should be consistent with the time value of money that is reflected in the other components of the liability. Thus, the accretion of interest represents the fact that the entity would have charged a different amount at contract inception if it had expected to recognise the profit represented by the contractual service margin at a different time.

BCA73 Some believe that interest should not be accreted on the contractual service margin on the grounds of simplicity and because they view the contractual

service margin as being a deferred credit rather than a representation of a component of an obligation. However, the IASB did not find these views persuasive.

Current, market-consistent estimates of the time value of money

BCA74 Paragraphs BCA26–BCA30 describe the IASB's reasoning for using current, market-consistent estimates of cash flows. Those reasons also apply to the discount rate applied to those cash flows. Accordingly, this Exposure Draft proposes that entities should discount cash flows using current, market-consistent discount rates.

Reflecting liquidity factors in the discount rate

BCA75 Discussions of the time value of money often use the notion of risk-free rates. Many use highly liquid, high-quality bonds as a proxy for risk-free rates. However, the holder can often sell such bonds in the market at short notice without incurring significant costs or affecting the market price. This means that the holder of such bonds acquires two things:

(a) a holding in an underlying non-tradable investment, paying a return that is higher than the observed return on the traded bond; and

(b) an embedded option to sell the investment, for which the holder pays an implicit premium through a reduction in the overall return.

In contrast, for many insurance contracts, the policyholder cannot sell the contract to a third party but is also unable to put it back to the entity, or perhaps can do so, but only by paying a significant penalty.

BCA76 The IASB concluded that, in principle, the discount rate for an insurance contract should reflect the liquidity characteristics of the item being measured. Thus, the discount rate should equal the return on the underlying non-tradable investment, because the holder cannot sell or put the liability without significant cost. There should be no deduction for the premium on the embedded put option, because no such put option is present in the liability.

BCA77 The IASB considered input from preparers of financial statements, academics and regulators on how to measure the liquidity premiums for an insurance contract. Their feedback suggested that there is not yet a consensus on how best to measure those effects, for example, how to separate liquidity effects from credit effects. The divergence in views became greater during the financial crisis of recent years, during which asset spreads widened dramatically.

BCA78 The IASB believes that it would not be appropriate, in a principle-based approach:

(a) to prescribe a discount rate that ignores the liquidity characteristics of the item being measured, or that uses an arbitrary benchmark (for example, high quality corporate bonds) as an attempt to develop a practical proxy for measuring the specific liquidity characteristics of the item being measured; or

(b) to provide detailed guidance on how to estimate liquidity adjustments.

BA79 However, the IASB observed that in estimating liquidity adjustments, an entity could apply either:

(a) a 'bottom-up' approach that would be based on risk-free rates, adjusted to include a liquidity premium; or

(b) a 'top-down' approach that would be based on the expected returns of a reference portfolio, adjusted to eliminate factors that were not relevant to the liability.

BCA80 This Exposure Draft confirms the proposal in the 2010 Exposure Draft that an entity should not consider its own credit risk when calculating the discount rate. This proposal is consistent with the view of many that own credit is not relevant to the measurement of a liability that must be fulfilled by the issuer. In developing this Exposure Draft, the IASB considered concerns that excluding own credit risk could lead to accounting mismatches, because the fair value of the assets backing insurance contracts includes changes in credit risk on those assets, while the measurement of the insurance contract would not include changes in credit risk on the liability. In the IASB's view, such mismatches would be partially economic, because the credit risk associated with the insurance contract differs from the credit risk of the assets held by the entity. Nonetheless, the IASB noted that an entity using a top-down approach to calculate the discount rate assumes that any part of the observed credit spreads that cannot be identified as relating to credit risk relates to liquidity and thus would not eliminate that unidentified risk from the reference discount rate. As a result, the discount rate for the liability would in part respond to changes in credit spreads and the effects of the mismatches might be reduced.

BCA81 The IASB noted that if there are no observable inputs for determining the discount rate, the entity should use an estimate that is consistent with the IASB's guidance on fair value measurement, in particular fair value measurements categorised within Level 3 of the fair value hierarchy. When applying that guidance, an entity would adjust an observable input that relates to an instrument whose characteristics differ from the characteristics of the liability being measured. Furthermore, because forecasts of unobservable inputs tend to put more weight on long term estimates than on short-term fluctuations, this counteracts concerns that current-period fluctuations in discount rates exaggerate the volatility of very long-dated liabilities.

BCA82 The IASB decided that it would not prescribe a default discount rate as a simpler alternative for calculating the appropriate discount rate to apply. In the IASB's view, it is not possible to simplify the implementation of the proposals by prescribing a rate while still achieving the objective of reflecting the characteristics of the liability.

Disclosure of yield curve

BCA83 The IASB noted that its proposal in paragraph B70(a)(iii) that an entity need not eliminate any part of the observed credit spreads that cannot be identified as relating to credit risk would reduce the comparability between the discount rates used by different entities because it would result in differences in the estimates of liquidity adjustments. Accordingly, the IASB proposes that an

entity should disclose the yield curve or range of yield curves that are used to discount the cash flows that do not depend on returns on underlying items, to supplement the proposed requirement in paragraph 83(b) that an entity disclose the methods and inputs that are used to estimate the discount rates. The IASB believes that disclosure of the yield curves used will allow users of financial statements to understand how those yield curves might differ from entity to entity.

Reflecting dependence on assets in the discount rate

BCA84 Some existing accounting approaches apply discount rates to insurance liabilities that are derived from the expected return on assets backing the liabilities, even when the cash flows arising from the liability do not depend on the cash flows of the underlying item. Proponents of that approach believe that doing so:

(a) prevents losses at contract inception for some contracts that are expected to be profitable overall and so reflects the most likely outcome of the insurance activity as a whole, taking into consideration the underwriting and investment functions together; and

(b) avoids the volatility that would arise if short-term fluctuations in asset spreads affect the measurement of the assets, but not the measurement of the liabilities. Because an entity holds those assets for the long term to enable it to fulfil its obligations under the insurance contracts it has issued, some believe that those fluctuations make it more difficult for users of financial statements to assess an entity's long-term performance.

BCA85 However, the IASB does not agree because it believes that:

(a) recognising a loss at contract inception is appropriate if the amount paid by the policyholder is insufficient both to cover the expected present value of the policyholder's benefits and claims and to compensate the entity for bearing the risk that those benefits might ultimately exceed the expected premiums.

(b) to the extent that market spreads affect assets and insurance contracts differently, useful information is provided about those economic mismatches, particularly about duration mismatches.

BCA86 The IASB rejected the application of an asset-based discount rate when the cash flows from the liability do not depend on returns on assets, because those rates are irrelevant for a useful measurement of the liability. The objective of the discount rate is to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability. Applying that objective:

(a) when the cash flows from assets (or other underlying items) affect the cash flows that arise from the liability, the characteristics of the liability reflect that dependence and the appropriate discount rate should reflect the dependence on the underlying items; and

(b) when the cash flows that arise from the liability are not expected to vary with returns on underlying items, the appropriate discount rate should exclude any factors that influence the underlying items but that are not relevant to the liability. Such factors include risks that are not present in the liability but are present in the financial instrument for which the market prices are observed. Thus, the discount rate should not capture the characteristics of those assets, even if the entity views those assets as backing those liabilities.

BCA87 Guarantees embedded in insurance contracts result in cash flows that are not expected to vary directly with returns on underlying items. Using a discount rate that reflects only the characteristics of the liability is needed to ensure that such effects are reported in the financial statements. Some view the cash flows that result from a guarantee embedded in an insurance contract as:

(a) varying with returns on underlying items in scenarios in which the guarantee amount is lower than the proportion of returns promised to the policyholder; and

(b) fixed in scenarios in which the guaranteed amount is higher than the proportion of returns promised to the policyholder.

However, the IASB does not regard these cash flows as varying directly with returns on underlying items because they are not expected to vary directly with such returns in all scenarios. Accordingly, an asset-based discount rate would not be appropriate for such cash flows.

BCA88 The IASB noted that a link between cash flows and underlying items could be captured by using replicating portfolio techniques, or portfolio techniques that have similar outcomes (see paragraphs B46–B48). A replicating portfolio is a theoretical portfolio of assets providing cash flows that exactly match the cash flows from the liability in all scenarios. If such a portfolio exists, then the appropriate discount rate(s) for the replicating portfolio would also be the appropriate discount rate(s) for the liability. If a replicating portfolio existed and could be measured directly, there would be no need to measure separately the cash flows and the adjustments for the part of the liability that is replicated by that portfolio. The measures of the replicating portfolio and the replicated cash flows arising from the liability would be identical.

Depicting risk and uncertainty (paragraphs 27 and B76–B82)

BCA89 This Exposure Draft proposes that entities should depict the risk and uncertainty that is inherent in insurance contracts by including a risk adjustment in the measurement of those contracts. The risk adjustment directly measures the remaining risk in the contract.

BCA90 This section discusses:

(a) the reasons for including a risk adjustment in the measurement of an insurance contract (see paragraphs BCA92–BCA96);

(b) the techniques for estimating the risk adjustment (see paragraphs BCA97–BCA99);

(c) the requirement to disclose a confidence level equivalent (see paragraphs BCA100–BCA102); and

(d) diversification benefits (see paragraphs BCA103–BCA104).

BCA91 The proposal that a risk adjustment should be included in the measurement of an insurance contract is a long-standing difference between the IASB's and the FASB's approaches. In the FASB's view the benefits of an explicit, remeasured risk adjustment do not outweigh the disadvantages that it believes will result from the inherent subjectivity of such a measure. Furthermore, the FASB believes that it is arbitrary to divide the profit that arises from measuring insurance contracts into an amount that relates to bearing risk and an amount that relates to coverage and other services.

Reasons for including a risk adjustment in the measurement of an insurance contract

BCA92 This Exposure Draft proposes that the risk adjustment should depict the compensation that the entity requires for bearing the uncertainty that is inherent in the cash flows that arise as the entity fulfils the portfolio of insurance contracts.

BCA93 In developing the objective of the risk adjustment, the IASB concluded that a risk adjustment should not represent:

(a) the compensation that a market participant would require for bearing the risk that is associated with the contract. As noted in paragraph BCA19, the measurement model is not intended to measure the current exit value or fair value, which reflects the transfer of the liability to a market participant. Consequently, the risk adjustment should not be determined as the amount of compensation that a market participant would require.

(b) an amount that would provide a high degree of certainty that the entity would be able to fulfil the contract. Although such an amount might be appropriate for some regulatory purposes, it is not compatible with the IASB's objective of providing information that will help users of financial statements make economic decisions.

(c) a shock absorber for the unexpected or to enhance the entity's solvency.

BCA94 Some, including the FASB, oppose the inclusion of a risk adjustment in the fulfilment cash flows because:

(a) no well-defined approach exists for developing risk adjustments that would meet the objective and provide consistency and comparability of results.

(b) some techniques are difficult to explain to users of financial statements and, for some techniques, it may be difficult to provide clear disclosures that would give users of financial statements an insight into the measure of the risk adjustment that results from the technique.

(c) although practitioners may, in time, develop tools that help them to assess whether the amount of a risk adjustment is appropriate for a given fact pattern, it is not possible to perform direct back-tests to assess retrospectively whether a particular adjustment was reasonable. Over time, an entity may be able to assess whether subsequent outcomes are in line with its previous estimates of probability distributions. However, it would be difficult, and perhaps impossible, to assess whether, for example, a decision to set a confidence level at a particular percentile was appropriate.

(d) developing systems to determine risk adjustments will involve cost, and some doubt that the benefits will be sufficient to justify that cost.

(e) the inclusion of an explicitly measured risk adjustment in identifying a loss at initial recognition is inconsistent with the IASB's 2011 Exposure Draft *Revenue from Contracts with Customers*.

(f) if the remeasurement of the risk adjustment for an existing portfolio of contracts results in a loss, that loss will reverse in later periods as the entity is released from that risk. Reporting a loss that is followed by an inevitable reversal of that loss may confuse some users of financial statements.

(g) they believe that, while the risk adjustment is a relevant concept for determining solvency, it risks introducing bias into the measurement of an insurance contract.

BCA95 However, the IASB proposes to require a separate risk adjustment because it believes that this:

(a) will result in an explicit measurement of risk that will provide a clearer insight into the core feature of insurance contracts. It will convey useful information to users of financial statements about the entity's view of the economic burden imposed on it by the presence of the risk associated with the entity's insurance contracts.

(b) will result in a profit recognition pattern that reflects both the profit that is recognised by bearing risk and the profit that is recognised by providing coverage and other services. As a result, the profit recognition pattern is more sensitive to the economic drivers of the contract.

(c) is conceptually consistent with market valuations of financial instruments and their pricing, both of which reflect the degree of risk associated with the financial instrument.

(d) will faithfully represent circumstances in which the entity has not charged sufficient premiums for bearing the risk that the claims might ultimately exceed expected premiums.

(e) will ensure that the measurement of an insurance contract includes a margin, which is essential to distinguish risk-generating liabilities from risk-free liabilities.

(f) will report changes in estimates about risk promptly and transparently.

BCA96 This Exposure Draft proposes that entities should consider the risk adjustment separately from the adjustment for the time value of money. The IASB observed that some existing accounting models combine these two adjustments by using risk-adjusted discount rates. However, that is not appropriate unless the risk is directly proportional to the amount of the liability and the remaining time to maturity. Insurance liabilities often do not have these characteristics. For example, the average risk in a portfolio of claims liabilities may rise over time because more complex claims may take longer to resolve. Similarly, lapse risk may affect cash inflows more than it affects cash outflows. Moreover, risk adjustments generally reduce the value of future cash inflows but increase the value of future cash outflows. A single risk-adjusted discount rate is unlikely to capture these differences in risk.

Techniques for measuring risk adjustments

BCA97 The 2010 Exposure Draft proposed:

(a) to limit the number of permitted techniques for determining the risk adjustment. The IASB had concluded that permitting a wide range of techniques to determine the risk adjustment could lead to diversity in practice, which might reduce the relevance of the resulting measurement and make it difficult for users of financial statements to compare risk adjustments made by different entities.

(b) to specify the level of aggregation to be used in determining the risk adjustment. Each of the techniques permitted by the 2010 Exposure Draft builds on a probability distribution of the underlying cash flows, and the shape of that distribution depends on the level at which the entity determines the risk adjustment.

BCA98 However, the IASB was persuaded that a more principle-based approach for measuring the risk adjustment would be consistent with the IASB's approach of not providing extensive guidance on how to determine a similar risk adjustment in IFRS 13. Furthermore, the IASB concluded that:

(a) limiting the number of techniques would conflict with the IASB's wish to set principle-based Standards. In particular situations, some techniques may be more applicable, or may be easier to implement, and it would not be practicable for a Standard to specify in detail every situation in which particular techniques would be appropriate. Furthermore, techniques may evolve over time. Specifying particular techniques might prevent the use of new techniques that are more suitable.

(b) the objective of the risk adjustment is to reflect the entity's perception of the economic burden of the risk it bears. It would contradict that objective to specify a level of aggregation for determining the risk adjustment that was not consistent with the way in which the entity views the burden of bearing risk.

BCA99 As a result, this Exposure Draft states only the principle that the risk adjustment should be the compensation that the entity requires for bearing the uncertainty that is inherent in the cash flows that arise as the entity fulfils the portfolio of insurance contracts.

Confidence level disclosure (paragraph 84)

BCA100 An important difference between the principle in this Exposure Draft and that in IFRS 13 is that the risk adjustment in this Exposure Draft relies on an entity's own perception of its degree of risk-aversion, rather than on a market participant's perception. In the IASB's view, the requirement in IFRS 13 to consider a market participant's view involves a degree of verifiability that would not be present in an entity-specific view. Accordingly, to allow users of financial statements to understand how the entity-specific assessment of risk aversion might differ from entity to entity, this Exposure Draft proposes that entities should disclose the confidence level to which the risk adjustment corresponds.

BCA101 Some are concerned that disclosure of the confidence level would be burdensome to prepare and may not provide information that is directly comparable. However, in the IASB's view, there are few other approaches that achieve its objective of quantitative disclosure that also allows users of financial statements to compare the risk adjustments using a consistent methodology across entities. In particular, the IASB noted that its objective would not be achieved by:

(a) the quantitative disclosure of the range of values of key inputs that are used to measure the risk adjustment from a market participant's perspective; and

(b) information about the relative magnitude of the risk adjustment compared to total insurance liabilities.

Accordingly, the IASB rejected these approaches.

BCA102 The IASB also considered whether a different risk adjustment technique, such as the cost of capital approach, should be used as the basis for comparison. However, although the cost of capital approach would often provide better information, the confidence level technique has the benefit of being relatively easy to communicate to users of financial statements and relatively easy to understand. Although the usefulness of the confidence level diminishes when the probability distribution is not statistically normal, which is often the case for insurance contracts, the cost of capital approach would be more complicated to calculate than the confidence level disclosure. Although the IASB expects that many entities will have the information needed to apply the cost of capital technique because that information will be required in order to comply with local regulatory requirements, it believes that it should not impose the more onerous requirements on entities when a simpler approach would be appropriate.

Diversification benefits

BCA103 The 2010 Exposure Draft proposed that the risk adjustment shall reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effects of diversification between that portfolio and other portfolios of insurance contracts.

BCA104 This Exposure Draft revises that proposal to be consistent with the objective of the risk adjustment, which is to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash

flows that arise as the entity fulfils the insurance contract. To be consistent with that objective, the risk adjustment reflects any diversification benefit that the entity considers when determining the amount of compensation it requires for bearing that uncertainty.

Measuring the contractual service margin (paragraphs 28, 30–32 and B68)

BCA105 This Exposure Draft proposes that entities should recognise a contractual service margin that eliminates any gains at contract inception by calibrating the measurement of the insurance contract to the transaction price. This would be consistent with the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*, which allocates the transaction price to the performance obligations in the contract. As defined in Appendix A, the contractual service margin represents the unearned profit that the entity will recognise by providing services over the coverage period. Because an entity would recognise as an immediate expense any amounts that would make the contractual service margin negative, the proposals would result in an entity recognising as an increase to the liability, and as a corresponding expense, any excess of the expected present value of the future cash outflows over the expected present value of the future cash inflows, adjusted for risk. Thus, the entity would recognise an increase in the liability and a corresponding expense if the contract is onerous.

BCA106 This section discusses:

(a) the recognition in profit or loss of the contractual service margin (see paragraphs BCA109–BCA112); and

(b) the level of aggregation for the contractual service margin (see paragraph BCA113).

BCA107 The IASB's proposals that changes in the estimates of cash flows relating to future coverage or services should be offset in the contractual service margin are discussed in paragraphs BC26–BC41.

BCA108 Paragraphs BCA71–BCA73 discuss accretion of interest on the contractual service margin.

Recognition in profit or loss

BCA109 As discussed in paragraphs BC26–BC32, the IASB views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Consistently with that view, this Exposure Draft proposes that the contractual service margin:

(a) should not be negative. That requirement would mean that, when the contractual service margin has been eliminated, the entity would recognise losses, thus faithfully depicting that the entity no longer expects profit from the contract.

(b) should be recognised over the coverage period in a pattern that reflects the provision of services as required by the contract. This proposal expresses, in a more principle-based way, the proposal in the 2010

Exposure Draft. That proposal was that an entity should recognise the contractual service margin on the basis of the passage of time but, if that pattern differs significantly from the passage of time, on the basis of the expected timing of incurred claims and benefits. The 2010 Exposure Draft assumed that the incurred claims and benefits reflected the expected value of providing insurance coverage and that insurance coverage was the primary service provided under the contract.

BCA110 The IASB considered a proposal to constrain the amount of contractual service margin recognised in an accounting period in a way similar to that in the 2011 Exposure Draft *Revenue from Contracts with Customers*, but rejected it. That proposal would have constrained the cumulative amount of contractual service margin that the entity recognises to the amount to which the entity is reasonably assured to be entitled. In the IASB's view, it would be inconsistent to constrain the amount of contractual service margin on a 'reasonably assured' basis when that margin is measured using an expected present value basis. This Exposure Draft proposes a current measurement model and the contractual service margin depicts a current view of the unearned profits relating to coverage and other services. Consequently, it would be more appropriate to use a recognition pattern for profit that is consistent with other Standards that use a current measurement model, such as financial assets or financial liabilities measured at fair value. For financial assets or financial liabilities measured at fair value through profit or loss, the IASB believes that fair value gains or losses that occur in the period provide useful information. Thus, with the exception of day one gains that are not supported by market inputs, gains arising on financial assets or financial liabilities at fair value are not subject to any constraint on the cumulative amount recognised even though fair value gains may reverse in future periods.

BCA111 The IASB considered the view that the pattern of profit recognition for insurance contracts in which the service is primarily asset management should be similar to that for revenue contracts for asset management services that have broadly similar economic features. An investment management fee charged by a fund manager would be recognised over the period of the fund management service (if that fee is not subject to any future performance conditions). Some believe that there is little economic difference between an insurance contract that stipulates that the entity receives a share of returns on an asset pool, and an asset management fee that is calculated as a percentage of the assets under management (which therefore means that the fee is based on the performance of the pool). However, the IASB believes that there is a substantive economic difference between an entity's share of returns on an asset pool and an investment management fee charged by a fund manager. In most cases, the fund manager does not control the underlying investments (based on the definition of control in IFRS 10 *Consolidated Financial Statements*). In addition, the fund manager would not suffer losses if there are overall losses on the pool. In contrast, the entity controls the assets of the pool and would suffer economic losses if there were overall losses on the pool. Consequently, the IASB concluded that an entity should report its economic interest in the assets in a way that is consistent with how it reports other assets in which it has an economic interest.

BCA112 Consistently with the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*, the settlement of a liability is not considered to be a service that is provided by the entity. Thus, the recognition period for the contractual service margin is the coverage period, because this is the period over which the entity provides the coverage and other services that are promised in the insurance contract. The margin that the entity recognises for bearing risk is recognised in profit or loss as it is released from risk in both the coverage and settlement periods. In contrast, the FASB proposal would recognise the margin, which is generally equivalent to the sum of the risk adjustment and contractual service margin at initial recognition, in profit or loss over the coverage and settlement period. The FASB proposal reflects that the margin comprises a component that relates to the provision of coverage and other services and a component for bearing risk. The provision of coverage and other services occurs during the coverage period but the entity bears risk during both the coverage and settlement period.

Level of aggregation (paragraph 32)

BCA113 This Exposure Draft specifies that an entity should aggregate insurance contracts into a portfolio of insurance contracts when determining the contractual service margin. However, it does not specify the level of aggregation for recognising the contractual service margin in profit or loss. The IASB proposes that when entities recognise the contractual service margin they should use a level of aggregation that ensures that the contractual service margin is recognised in line with the pattern of services provided under the contracts to which they relate. This would mean that when the coverage period of each contract has ended, the contractual service margin relating to that contract should be fully recognised. In practice, this may result in a smaller unit of account than the portfolio that entities would generally use to manage contracts, and may require entities to group together contracts that have similar contract inception dates, coverage periods and service profiles. Another approach would be to determine the recognition of the contractual service margin at an individual contract level, but the IASB concluded that requiring that approach in all circumstances might be onerous.

Foreign currency (paragraph 20)

BCA114 This Exposure Draft proposes that an insurance contract should be treated as a monetary item for foreign currency translation in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. This would apply for both the fulfilment cash flows and the contractual service margin. The conclusion that the insurance contract is a monetary item does not change if an entity measures that contract using the simplified approach for the measurement of the liability for the remaining coverage as proposed in paragraphs 35–40 of this Exposure Draft.

BCA115 In accordance with IAS 21, the entity would classify as monetary items the insurance contract components that relate both to the expected present value of cash flows and to the risk adjustment, which is measured using the amount, timing and uncertainty of those cash flows, but might classify the contractual service margin component as non-monetary because it is similar to prepayments

for goods and services. The IASB believes that it would be a more faithful representation of the transaction to treat all components of the measurement of an insurance contract denominated in a single currency as a monetary item, and therefore to recognise any changes in value due to changes in exchange rates as translation gains or losses. Because the proposed measurement model focuses on estimates of future cash flows, it would be more appropriate to view an insurance contract as a whole as a monetary item.

Simplified approach for measuring the liability for the remaining coverage (paragraphs 35–40)

BCA116 This Exposure Draft proposes that an entity may elect to simplify the measurement of some insurance contracts by applying a premium-allocation approach to measure the liability for the remaining coverage.

BCA117 The premium-allocation approach proposed in this Exposure Draft is similar to the customer consideration approach in the 2011 Exposure Draft *Revenue from Contracts with Customers*. In the premium-allocation approach, the initial measurement of the liability equals the premium received, and the entity does not identify explicitly the present value of future cash flows, the effects of risk and the time value of money unless the contract is onerous. Nevertheless, that initial measurement can be described as containing those components implicitly, as follows:

(a) an estimate of the future cash flows, made at contract inception;

(b) the effect of risk, measured at contract inception;

(c) the effect of the time value of money, measured at contract inception; and

(d) a contractual service margin, if any, measured at contract inception.

There is no liability for incurred claims at contract inception.

BCA118 Subsequently, the liability for the remaining coverage (known in the 2010 Exposure Draft as the 'pre-claims liability') is recognised over the coverage period in a pattern that reflects the pattern of services provided by the contract.

BCA119 The 2010 Exposure Draft proposed that the premium-allocation approach would be required for contracts that had a coverage period of approximately one year or less, provided that the contract contained no embedded derivatives that significantly affect variability in cash flows. In those cases, the IASB believed that the liability for the remaining coverage determined using the premium-allocation approach would be a reasonable approximation of the fulfilment cash flows and the contractual service margin, and achieves a similar result at a lower cost. This is because there are unlikely to be significant variations in the relative size of the components described in paragraph BCA117, and those components are likely to evolve in a stable way. If significant changes in estimates were expected to occur during the coverage period of a short-duration contract, those changes would be more likely to be unfavourable (leading to losses) than favourable (leading to gains). Accordingly, those losses would be identified because of the requirement to recognise an additional

liability when the contract becomes onerous. Thus, requiring an entity to apply the full measurement model for these contracts would not generate sufficient benefits to justify the costs of adopting the more difficult approach.

BCA120 Respondents to the 2010 Exposure Draft were concerned that those proposals would result in different accounting for similar products because there would be an arbitrary distinction for determining which contracts are eligible for the premium-allocation approach based on time. In addition, many thought that the premium-allocation approach should be optional, particularly because of operational concerns for entities that issue contracts qualifying for the premium-allocation approach as well as those that do not qualify.

BCA121 The IASB notes that the FASB views the premium-allocation approach as a separate model that is more appropriate for some types of insurance contracts. For those reasons the FASB proposes that the premium-allocation approach should be required to account for contracts meeting specified criteria. However, the IASB concluded that an entity should be permitted, but not required, to apply the premium-allocation approach when it provides a reasonable approximation to the general requirements of this Exposure Draft because it views the premium-allocation approach as a simplification to the main approach proposed in this Exposure Draft. The IASB also decided to provide application guidance that an entity could assume, without further investigation, that the approach provides a reasonable approximation if:

(a) the coverage period for the contract is one year or less; or

(b) significant changes in estimates of fulfilment cash flows are not likely to occur before the claims occur.

BCA122 To maintain consistency with the measurement for insurance contracts generally, the 2010 Exposure Draft proposed that the premium-allocation approach should include the following features:

(a) interest would be accreted on the insurance contract asset or liability;

(b) the entity would recognise an additional liability when the contracts are onerous; and

(c) the incremental acquisition costs would be deferred and presented as a deduction from the part of the premium allocated to the remaining coverage period. Those deferred incremental acquisition costs would be recognised as an expense over time in a pattern that is consistent with the pattern in which the premium is recognised as revenue.

BCA123 Many respondents to the 2010 Exposure Draft considered these features to overcomplicate what had been intended to be a simplification. Accordingly, this Exposure Draft proposes to simplify the 2010 Exposure Draft approach, in particular, proposing that entities:

(a) should accrete interest on the liability for the remaining coverage only for contracts that have a significant financing component. When the period between premiums being due and the provision of coverage is one year or less, the contract is deemed not to have a significant financing component.

(b) need not discount claims that are expected to be paid within one year.

(c) need to assess whether contracts are onerous only when facts and circumstances indicate that contracts have become onerous.

(d) for contracts with a coverage period of one year or less, would be permitted to recognise all acquisition costs as an expense when incurred.

BCA124 The premium-allocation approach measures the insurance contract using estimates made at contract inception and does not update those estimates in the measurement of the liability for the remaining coverage unless the contract is onerous. Accordingly, this Exposure Draft proposes that the discount rate used to reflect the time value of money in the premium-allocation approach should be set when the contract is initially recognised. Consistently with that approach, interest expense in profit or loss for the liability for incurred claims would be measured using the rate that applied when the contract was initially recognised.

Reinsurance contracts held (paragraphs 41–42)

BCA125 A reinsurance contract is one type of insurance contract. The IASB has identified no reason to apply different requirements to direct insurance contracts and reinsurance contracts that an entity issues. Consequently, this Exposure Draft proposes that entities that issue reinsurance contracts should use the same recognition and measurement approach as those for other insurance contracts that they issue.

BCA126 This Exposure Draft would also apply to reinsurance contracts held by an entity (ie in which the entity is the cedant). This Exposure Draft proposes that a reinsurance contract held should be accounted for separately from the underlying direct contracts it relates to. This is because an entity that holds a reinsurance contract does not normally have a right to offset the amounts due from the reinsurer against amounts it owes to the underlying policyholder. Accordingly, accounting for a reinsurance contract held separately from the underlying insurance contract gives a clearer picture of the entity's rights and obligations and the related income and expense.

BCA127 The amount paid for reinsurance coverage by an entity consists of premiums paid by the entity, less any amounts paid by the reinsurer to the cedant to compensate it for expenses it incurs such as underwriting or acquisition expenses ('ceding commissions'). That amount can be viewed as payment for the following:

(a) the reinsurer's share of the expected present value of the cash flows generated by the underlying direct insurance contract(s). That amount includes an adjustment for the risk that the reinsurer may dispute coverage or fail to satisfy its obligations under the reinsurance contract held; and

(b) a contractual service margin that makes the initial measurement of the reinsurance asset equal to the premium paid at inception. This margin depends on the pricing of the reinsurance contract held and,

consequently, may differ from the contractual service margin arising for the underlying direct insurance contract(s).

BCA128 When measuring the expected present value of the cash flows from an insurance contract that the entity issues, the IASB proposes to use the same approach that would be used when measuring the reinsurer's share of the expected present value of the cash flows from the reinsurance contract held. When estimating cash flows and the associated adjustments for the risk and the time value of money arising from a reinsurance contract held, the entity would use assumptions that are consistent with those it uses for the underlying contracts. As a result, the cash flows used to measure the reinsurance contract held would reflect the extent to which those cash flows depend on the cash flows of the contracts they cover. However, although both the cedant and the reinsurer would measure their contractual rights and obligations on the same basis, in practice they would not necessarily arrive at the same amount. The IASB is not proposing 'mirror accounting' for reinsurance contracts held. Differences may arise because the estimates are based on access to different information and different experiences as well as differences in the composition of their portfolios, for example, by including different adjustments for diversification effects.

BCA129 Consistently with the proposals for the measurement of insurance contracts that an entity issues, the entity would also be able to apply the premium-allocation approach to simplify the measurement of reinsurance contracts held, provided that the resulting measurement is a reasonable approximation to the results that would be obtained by applying the general requirements of the proposed Standard.

BCA130 This Exposure Draft contains modifications to reflect the fact that:

(a) reinsurance contracts held are generally assets, rather than liabilities; and

(b) entities holding reinsurance contracts generally pay margin to the reinsurer as an implicit part of the premium, rather than making profits from the reinsurance contracts.

BCA131 The following paragraphs discuss the following modifications to the general principles in this Exposure Draft in relation to reinsurance contracts held:

(a) recognition (see paragraphs BCA132–BCA134);

(b) derecognition (see paragraph BCA135);

(c) risk adjustment (see paragraphs BCA136–BCA138);

(d) contractual service margin (see paragraphs BCA139–BCA143); and

(e) contract modification (see paragraph BCA144).

Recognition for reinsurance contracts held (paragraph 41(a))

BCA132 Many reinsurance arrangements are designed to cover the claims that are incurred under direct contracts that are written during a specified period. In some cases the reinsurance contract covers the losses of individual contracts on

a proportionate basis. In other cases the reinsurance contract covers the aggregate losses from a portfolio of underlying contracts over a specified amount.

BCA133 The IASB proposes to simplify the application of the principle that a contract should be recognised from the date that the entity is exposed to risk under the contract as follows:

(a) when the reinsurance contract held covers the loss of a portfolio of insurance contracts on a proportionate basis, it would be recognised when the coverage period of the underlying contracts begins and the direct insurance contract is recognised. This ensures that the expected reimbursement from the reinsurance contracts held is recognised at the same time as the expected payments made under the underlying contracts.

(b) when the reinsurance contract held covers aggregate losses arising from a portfolio of insurance contracts over a specified amount, the reinsurance contract held would be recognised when the coverage period of the reinsurance contract begins. In these contracts the entity is exposed to risk—that the underlying losses will exceed the threshold—from the beginning of the reinsurance contract held because the losses that cause the threshold to be exceeded accumulate throughout the coverage period.

BCA134 For reinsurance contracts held in the pre-coverage period, a cedant should recognise a reinsurance asset at the expected present value of any expected recoveries related to underlying contracts for which it has recognised an onerous contract liability.

Derecognition (paragraph 51)

BCA135 An entity does not derecognise insurance contract liabilities until the contractual obligations are extinguished by discharge, cancellation or expiry. It follows that a cedant typically would not derecognise the related direct insurance liabilities upon entering into a reinsurance contract.

Cash flows in a reinsurance contract held (paragraph 41(b))

BCA136 As proposed in paragraph 41(b) of this Exposure Draft, cash flows for a reinsurance contract held should be estimated using assumptions that are consistent with those used for the underlying direct insurance contracts. In addition, this Exposure Draft proposes that entities should:

(a) treat cash flows, including ceding commissions, that are contingent on claims or benefits experience of the underlying contracts, as part of the claims that are expected to be reimbursed under the reinsurance contracts held, unless these cash flows need to be accounted for as investment components. In the IASB's view, the economic effects of changes in those cash flows is equivalent to reimbursing a different amount of claims than expected.

(b) treat ceding commissions that are not contingent on the occurrence of claims of the underlying contract as a reduction of the premiums to be paid to the reinsurer and present the net amount in the statement of profit or loss and other comprehensive income. In the IASB's view, the economic effect of such ceding commissions is equivalent to charging a lower premium with no ceding commission.

(c) reflect, in the measurement of cash flows, expected credit losses. This is discussed in paragraphs BCA137–BCA138.

BCA137 A cedant faces the risk that the reinsurer may default, or may dispute whether a valid claim exists for an insured event. Consistently with the IASB's Exposure Draft *Financial Instruments: Expected Credit Losses*, this Exposure Draft proposes that the estimates of expected credit losses should be based on expected values.[7] Hence, estimates of the amounts and timing of cash flows are the probability-weighted outcomes.

BCA138 This Exposure Draft proposes that all changes in the initial expected credit losses should be recognised as gains or losses in the statement of profit or loss and other comprehensive income instead of being offset against the contractual service margin. In the IASB's view, differences from the initial expected credit losses affect the coverage or services that were originally promised in the contract. They do not alter the profitability of that coverage or those services. Furthermore, any changes from the initial expected credit losses are economic events that the IASB believes should be reflected as gains and losses when they occur. Accordingly, the IASB believes that it would be appropriate to reflect that change in the amount of service in profit or loss. This would result in consistent accounting for expected credit losses between reinsurance contracts held and purchased and originated credit-impaired financial assets.

Gains and losses on buying reinsurance (paragraph 41(c))

BCA139 The amount paid by the cedant would typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment. Thus, a positive contractual service margin, which represents a net expense of purchasing reinsurance, would typically be recognised at the initial recognition of a reinsurance contract held. The IASB considered whether the contractual service margin in the reinsurance contract held could be negative if, as happens in rare cases, the amount paid by the cedant is less than the expected present value of cash flows plus the risk adjustment. Such a negative gain would represent a net gain in purchasing reinsurance. The most likely causes of such a negative difference would be either of the following:

(a) an overstatement of the underlying direct insurance contract(s). A cedant would evaluate this by reviewing the measurement of the direct contract(s).

(b) favourable pricing by the reinsurer, for example, as a result of diversification benefits that are not available to the cedant.

7 The FASB proposes that the credit risk of reinsurers is accounted for by the cedant on an expected value basis that is in accordance with the proposed US GAAP guidance on credit losses.

BCA140 In the 2010 Exposure Draft, the IASB proposed that entities should recognise a gain when such a negative difference arose. The IASB proposed this for symmetry with the underlying model and to be consistent with the IASB's conclusion that the contractual service margin for the underlying contract should not be negative. However, this Exposure Draft proposes that entities should instead recognise the negative difference over the coverage period of the reinsurance contract held. The IASB was persuaded by the view that the apparent gain at contract inception represented a reduction in the cost of purchasing reinsurance, and that it would be appropriate to recognise that reduction in cost over the coverage period as services are received.

BCA141 The IASB also believes that the net expense of purchasing reinsurance should be recognised over the coverage period as services are received unless the reinsurance coverage is for events that have already occurred. For reinsurance contracts held that provide coverage for events that have already occurred, the IASB concluded that entities should recognise the whole of the apparent loss at contract inception because the coverage period of the underlying contracts has expired.

BCA142 The IASB considered the view that the amount of the contractual service margin included in the measurement of the reinsurance contract held should be proportional to the margin on the underlying contract instead of being measured separately by reference to the reinsurance premium. Under this approach, any difference between the amount recognised for the underlying insurance contract and the reinsurance premium would be recognised in profit or loss when the contract is initially recognised. That approach would depict a gain or loss that is equal to the shortfall or excess of the reinsurance premium that the entity pays to the reinsurer over and above the premium that the entity receives from the policyholder. The unearned profit from the underlying contract would be offset by an equal and opposite expense for the reinsurance premium. However, in the IASB's view, measuring the reinsurance contract held on the basis of the premium that the entity received for the underlying contract when that premium does not directly affect the cash flows arising from the reinsurance contract held would be contrary to viewing the reinsurance contract held and the underlying contract as separate contracts. It also does not reflect the economics of the reinsurance contract the entity holds: that the expense of purchasing the reinsurance contract is equal to the whole of the consideration paid for the reinsurance contract.

BCA143 For the measurement of insurance contracts that the entity issues, this Exposure Draft proposes that the contractual service margin can never be negative, but can be rebuilt. That would mean that entities would recognise losses when the contractual service margin has been eliminated, depicting that the entity no longer expects profit from the contract and would depict any increase in expected profit by an increase in the contractual service margin. This Exposure Draft does not include a limit on the amount by which the contractual service margin of a reinsurance contract held could be adjusted as a result of changes in estimates of cash flows. In the IASB's view, the contractual service margin for a reinsurance contract held is different from that for an insurance contract issued: it reports the expense that the entity incurs when purchasing reinsurance

coverage rather than the profit it will make by selling the insurance contract. Accordingly, there is no limit on the amount of adjustment to the contractual service margin for reinsurance contracts held, subject to the amount of premium paid to the reinsurer.

Contract modification (paragraph 52)

BCA144 This Exposure Draft proposes that entities that issue or hold reinsurance contracts should recognise any gains or losses on contract modification as an adjustment to claims or benefits and should not gross up the premiums, claims or benefits when recognising the transaction in the statement of profit or loss and other comprehensive income. In the IASB's view this proposal would provide a faithful representation of the economic substance of modifications of reinsurance contracts held as a negotiated settlement of the cedant's reinsurance recoverable/reinsurer's liability.

Portfolio transfers and business combinations (paragraphs 43–46)

BCA145 The IASB proposes that an entity would treat the consideration for insurance contracts that are acquired in a portfolio transfer or a business combination as a cash flow that occurs immediately before initial recognition, ie as a pre-coverage cash flow. This would mean that the entity would determine the contractual service margin, in accordance with the general requirements of the proposed Standard, in a way that reflects the consideration paid for the contract.

BCA146 Thus, in accordance with paragraph 28, the entity would determine the contractual service margin for insurance contracts that are acquired in a portfolio transfer or a business combination at an amount that is equal and opposite to the sum of the fulfilment cash flows at initial recognition plus any pre-coverage cash flows. There is no contractual service margin if the sum of the fulfilment cash flows at initial recognition and any pre-coverage cash flows is greater than zero, and any excess of that amount over zero is recognised:

(a) immediately as an expense in profit or loss for a portfolio transfer, in the same way as for insurance contracts that the entity issues; and

(b) as an adjustment to the initial measurement of the gain on business combination or goodwill for a business combination. Although this proposal would require a new measurement exception to the principle of fair value measurement in IFRS 3 *Business Combinations*, similar exceptions are contained in that Standard for other cases in which liabilities, such as pension liabilities, are measured on a current value basis that is not fair value.

BCA147 The proposal described in paragraphs BCA145–BCA146 means that an entity would recognise the insurance contracts that it acquires in either a portfolio transfer or a business combination at the amount of the fulfilment cash flows rather than the amount of the consideration (which equals the fair value in a business combination) when:

(a) the contract is in a liability position at the date of the portfolio transfer or business combination and the fulfilment cash flows are higher than fair value; or

(b) the contract is in an asset position at the date of the portfolio transfer or business combination and the fulfilment cash flows are lower than fair value.

BCA148 The IASB considered how the amount of the fulfilment cash flows could differ from the amount of the consideration received (ie fair value). The most likely cause is the fact that the fulfilment cash flows do not include the risk of non-performance by the entity. For contracts in a liability position acquired in a portfolio transfer, the IASB concluded that the immediate recognition of a loss in such circumstances faithfully represents the fact that the entity has acquired an obligation that it expected to fulfil, but it received a lower price because of the risk that it might not be able to fulfil the obligation.

BCA149 For a business combination, the IASB concluded that the most likely cause for the fulfilment cash flows differing from the fair value is that the acquirer may have been willing to pay more for the contracts because of other synergies that the fulfilment cash flows provide. Consequently, the recognition of that difference as an adjustment to the gain on business combination or goodwill is consistent with the accounting for similar effects in a business combination.

BCA150 The discount rate used to measure interest expense or interest income in profit or loss for insurance contracts and reinsurance contracts acquired in a portfolio transfer or business combination is the rate at the date of initial recognition. The date of initial recognition by the entity is the date of the portfolio transfer or business combination, respectively.

Scope and definition (paragraphs 3–7)

BCA151 Some argued that the proposed Standard should deal with all aspects of financial reporting by entities that issue insurance contracts to ensure that the financial reporting for such entities is internally consistent. They noted that regulatory requirements, and some national accounting requirements, often cover all aspects of an entity's insurance business. However, the IASB proposes that this Exposure Draft should apply to insurance contracts of all entities and does not address other aspects of accounting by entities that issue insurance contracts. It decided to take an approach based on the type of activity rather than on the type of the entity because:

(a) it would be undesirable for an entity that issues insurance contracts to account for a transaction in one way and for an entity that does not issue insurance contracts to account for the same transaction in a different way;

(b) the IASB does not intend to reopen issues addressed by other Standards, unless specific features of insurance contracts justify a different treatment; and

(c) it would be difficult, and perhaps impossible, to create a robust definition of an insurer that could be applied consistently from country to country. Among other things, an increasing number of entities have major activities in both insurance and other areas.

BCA152 Accordingly, the IASB's proposals would apply to all insurance contracts as defined in this Exposure Draft throughout the life of those contracts.

BCA153 In general, this Exposure Draft does not deal with other assets and liabilities of entities that issue insurance contracts, because those assets and liabilities would be within the scope of other Standards. However, this Exposure Draft proposes the following exceptions:

(a) it would apply to investment contracts with a discretionary participation feature provided that the issuer also issues insurance contracts. In the IASB's view, the proposals in this Exposure Draft result in a more faithful representation of such contracts than would be the case when applying other Standards. The IASB believes that investment contracts with a discretionary participation feature are exclusively issued by entities that issue insurance contracts (see paragraphs BCA170–BCA177).

(b) it would apply to financial guarantee contracts, provided that the entity has previously asserted that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts for them. The IASB notes that it has previously found it difficult to distinguish such contracts from credit insurance and does not view work in this area as a high priority (see paragraphs BCA184–BCA188).

(c) it would amend other Standards to permit an entity to measure the entity's own shares, own debt and owner-occupied property at fair value when held in an investment fund that issues notional units in linked contracts. The IASB believes that for many contracts that specify a link to returns on underlying items, those underlying items include a mix of assets that are all measured at fair value. It would therefore be onerous for entities to separately identify own shares, own debt and owner-occupied property and account for them differently (see paragraph BC49).

BCA154 This Exposure Draft does not deal with accounting for insurance contracts by policyholders other than cedants. IAS 37 addresses accounting for reimbursements arising from insurance contracts for expenditure required to settle a provision. IAS 16 *Property, Plant and Equipment* addresses some aspects of reimbursement under an insurance contract for the impairment or loss of property, plant and equipment. Furthermore, IAS 8 specifies a hierarchy of action that an entity should use when developing an accounting policy if no Standard applies specifically to an item. Accordingly, the IASB does not view work on policyholder accounting as a high priority.

Definition of an insurance contract (Appendix A and paragraphs B2–B30)

BCA155 The definition of an insurance contract determines which contracts are within the scope of this Exposure Draft and not within the scope of other Standards. The definition of an insurance contract proposed in this Exposure Draft is the same as the definition in IFRS 4, with some clarifications to the related guidance in Appendix B of IFRS 4.

BCA156 When developing this Exposure Draft, the IASB compared the IFRS 4 definition with US GAAP requirements to identify possible improvements that could be made to that definition and considered the following main differences:

(a) *use of 'compensation' rather than 'indemnification' when describing the insurance contract benefit.* In the IASB's view, these terms have broadly the same meaning. However, describing an insurance contract as compensating the policyholder may be more intuitive in some instances, for example, when referring to a death benefit in a life insurance contract that compensates the beneficiary with a specified amount for the loss of the insured's life. Accordingly, the IASB retained 'compensation' in the definition of an insurance contract.

(b) *the role of timing risk.* US GAAP requires the presence of both timing risk and underwriting risk in an insurance contract, whereas IFRS 4 treats contracts that transfer either underwriting risk or timing risk as insurance contracts. In US GAAP, much of the pressure on the notions of underwriting risk and timing risk arises because the accounting for some insurance contracts does not require entities to discount the expected future cash flows when measuring the insurance contract. That pressure is not present in the model that is proposed in this Exposure Draft; that model would discount cash flows except when the effect is insignificant. Consequently, the IASB does not require the presence of both timing risk and underwriting risk. However, this Exposure Draft confirms a proposal introduced in the 2010 Exposure Draft that an entity should consider the time value of money when assessing whether the additional benefits payable if an insured event occurs are significant (see paragraph B20).

(c) *the notion of a loss.* When an entity assesses whether an insurance contract transfers significant insurance risk, IFRS 4 requires the entity to consider whether an insured event could cause the issuer to pay amounts that are significant in any scenario that has commercial substance (see paragraph B23 of IFRS 4 and paragraph B18 of this Exposure Draft). The IASB understands that, in practice, entities applying US GAAP consider whether it is reasonably possible that the present value of net cash outflows can exceed by a significant amount the present value of premiums. In paragraph B19, the IASB proposes to include, as an additional test, that a contract does not transfer insurance risk if there is no scenario with commercial substance in which the present value of the net cash outflows that is paid by the entity can exceed the present value of the premiums. Although the IASB has no specific reason to think that the absence of such a test in IFRS 4 has led to an inappropriate

classification of contracts, the inclusion of such a test is more closely aligned with what the IASB understands to be practice under US GAAP. The IASB noted that the inclusion of such a test also necessitates the inclusion of another aspect of US GAAP because some reinsurance contracts may not expose the issuer to the possibility of a significant loss, even though they directly reinsure contracts that meet the definition of an insurance contract. Accordingly, this Exposure Draft clarifies that a reinsurance contract is deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contract is assumed by the reinsurer, even if the reinsurer is not exposed to a loss from the contract.

BCA157 The following aspects of the definition of an insurance contract are discussed below:

(a) insurance risk (see paragraphs BCA158–BCA159);

(b) insurable interest (see paragraphs BCA160–BCA162);

(c) quantity of insurance risk (see paragraphs BCA163–BCA167);

(d) expiry of insurance-contingent rights and obligations (see paragraph BCA168); and

(e) combination of contracts (see paragraph BCA169).

Insurance risk (Appendix A and paragraphs B3–B30)

BCA158 The definition of an insurance contract in IFRS focuses on the feature that causes accounting problems that are unique to insurance contracts, namely, insurance risk.

BCA159 Some contracts have the legal form of insurance contracts but do not transfer significant insurance risk to the issuer. This Exposure Draft does not treat such contracts as insurance contracts even though the contracts are traditionally described as insurance contracts and may be subject to regulation by insurance supervisors. Thus, this Exposure Draft proposes a definition of an insurance contract that reflects the insurance contract's economic substance and not merely its legal form.

Insurable interest (paragraphs B7–B16)

BCA160 The definition of an insurance contract reflects the risk that the entity accepts from the policyholder by agreeing to compensate the policyholder if an uncertain event adversely affects the policyholder. The notion that the uncertain event must have an adverse effect on the policyholder is known as 'insurable interest'. The notion is needed to avoid encompassing gambling in the definition of insurance. Furthermore, without the reference to 'adverse effect', the definition might have captured any prepaid contract to provide services whose cost is uncertain. This would extend the meaning of the term 'insurance contract' beyond its traditional meaning.

BCA161 Some argue that the definition of an insurance contract should not require an insurable interest and that it would be preferable to eliminate the notion of

insurable interest and replace it with the notion that insurance is a business that involves assembling risks into a pool that is managed together, because:

(a) contracts that require payment if a specified uncertain future event occurs cause economic exposure similar to insurance contracts, whether the other party has an insurable interest or not.

(b) in life insurance, there might not be a direct link between the adverse event and the financial loss to the policyholder. Moreover, it is not clear that survival adversely affects an annuitant. Any contract that is contingent on human life should meet the definition of an insurance contract.

(c) the notion of insurable interest excludes some contracts that are, in substance, used as insurance, for example, weather derivatives. The test should be whether there is a reasonable expectation of some indemnification to policyholders. A tradable contract could be brought within the scope of the Standards on financial instruments.

BCA162 The IASB decided to retain the notion of insurable interest because it gives a principle-based distinction, particularly between insurance contracts and other contracts that are used for hedging. Moreover, the IASB decided that it was unnecessary to refine this notion for a life insurance contract or life-contingent annuity because such contracts typically provide for a predetermined amount to quantify the adverse effect (see paragraph B12).

Quantity of insurance risk (paragraphs B18–B23)

BCA163 Paragraphs B18–B23 of Appendix B of this Exposure Draft discuss how much insurance risk must be present before a contract qualifies as an insurance contract. In developing this material, the IASB considered the criteria in US GAAP for a contract to be treated as an insurance contract, which includes the notion that there should be a 'reasonable possibility' of a 'significant loss'.

BCA164 The IASB observed that some practitioners use the following guideline when applying US GAAP: a reasonable possibility of a significant loss is at least 10 per cent probability of at least a 10 per cent loss. In the light of this, the IASB considered whether it should define the amount of insurance risk in quantitative terms in relation to, for example:

(a) the probability that payments under the contract will exceed the expected (ie probability-weighted average) level of payments; or

(b) a measurement of the range of outcomes, such as the range between the highest and lowest levels of payments or the standard deviation of payments.

BCA165 However, quantitative guidance creates an arbitrary dividing line that results in different accounting treatments for similar transactions that fall marginally on different sides of the line. It also creates opportunities for accounting arbitrage by encouraging transactions that fall marginally on one side of the line or the other. For these reasons, IFRS 4 and this Exposure Draft, like US GAAP, do not include quantitative guidance.

BCA166 The IASB also considered whether it should define the significance of insurance risk by referring to materiality, which the *Conceptual Framework* describes as follows: "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements." However, a single contract, or even a single book of similar contracts, would rarely generate a loss that is material in relation to the financial statements as a whole. Although entities manage, and often measure, contracts on a portfolio basis, the contractual rights and obligations arise from individual contracts. Consequently, IFRS 4 and this Exposure Draft define the significance of insurance risk in relation to the individual contract (see paragraph B22).

BCA167 The IASB also rejected the notion of defining the significance of insurance risk by expressing the expected (ie probability-weighted) average of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes, or as a proportion of the premium. This notion had some intuitive appeal because it would consider both amount and probability. However, it would have meant that a contract could start as a financial liability and become an insurance contract as time passes or probabilities are reassessed. In the IASB's view, requiring the continuous monitoring of whether a contract meets the definition of an insurance contract over the life of the contract would be too onerous. Instead, the IASB adopted an approach that requires the decision about whether a contract is an insurance contract to be made once only, at contract inception. The guidance in paragraphs B18–B23 of this Exposure Draft focuses on whether insured events could cause an entity to pay additional amounts, judged on a contract-by-contract basis. Furthermore, paragraph B25 states that an insurance contract remains an insurance contract until all rights and obligations expire.

Expiry of insurance-contingent rights and obligations

BCA168 Some respondents suggested that a contract should not be regarded as an insurance contract if the insurance-contingent rights and obligations expire after a very short time. This Exposure Draft includes material that may be relevant: paragraph B18 explains the need to ignore scenarios that lack commercial substance and paragraph B21(b) notes that there is no significant transfer of pre-existing risk in some contracts that waive surrender penalties on death.

Combination of contracts (paragraph 8)

BCA169 This Exposure Draft proposes to incorporate from the 2011 Exposure Draft *Revenue from Contracts with Customers* requirements for when an entity should combine two or more contracts and account for them as a single contract. The principle in that Exposure Draft is that contracts should be combined if they are negotiated as a package with a single commercial objective and if the amount of consideration to be paid in one contract depends on the price or performance of the other contract. The IASB's view is that this principle applies equally to insurance contracts. If those contracts were not combined, then the amount of consideration allocated to each contract might not faithfully depict the obligations created by the contracts.

Investment contracts with a discretionary participation feature (paragraphs 47–48)

BCA170 The IASB proposes that issuers of investment contracts with a discretionary participation feature (known in the 2010 Exposure Draft as 'financial instruments with discretionary participation features') should apply this Exposure Draft to those contracts provided that the issuer also issues insurance contracts. Because investment contracts with a discretionary participation feature do not transfer insurance risk, and do not have a coverage period, the proposed requirements of this Exposure Draft would be modified for such contracts.

BCA171 Although investment contracts with a discretionary participation feature do not meet the proposed definition of an insurance contract, the advantages of treating them in the same way as insurance contracts rather than as financial instruments are that:

(a) investment contracts with a discretionary participation feature and insurance contracts that specify a link to returns on underlying items are sometimes linked to the same underlying pool of assets. Sometimes investment contracts with a discretionary participation feature even share in the performance of insurance contracts. Using the same approach for both types of contracts will produce more relevant information for users of financial statements because it enhances comparability within the entity and simplifies the accounting for those contracts. For example, some cash flow distributions to participating policyholders are made in aggregate both for insurance contracts that specify a link to returns on underlying items and for investment contracts with a discretionary participation feature. This makes it challenging to apply different accounting models to different parts of that aggregate participation.

(b) both of these types of contract often have characteristics, such as long maturities, recurring premiums and high acquisition costs, that are more commonly found in insurance contracts than in most other financial instruments. The proposed model for insurance contracts was developed with the specific aim of generating useful information about contracts containing these features.

(c) investment contracts with a discretionary participation feature contain a complex package of interdependent options and guarantees, such as minimum guarantees, surrender options, conversion options and paid-up options. Accordingly, some of these features might be separated into components in accordance with the IASB's existing requirements for financial liabilities. Splitting these contracts into components with different accounting treatments would result in the same problems that would arise when splitting insurance contracts. In the IASB's view, the accounting model it has developed for insurance contracts would be more appropriate for these types of contracts.

BCA172 Accordingly, the IASB proposes that those contracts should be within the scope of the proposed Standard. The FASB does not propose that such contracts should

be accounted for as insurance contracts because they do not meet the definition of an insurance contract and existing US GAAP guidance for financial liabilities addresses the features of these contracts.

BCA173 This Exposure Draft would identify the investment contracts with a discretionary participation feature that should be within its scope on the basis of the existing definition of a discretionary participation feature in IFRS 4. The 2010 Exposure Draft would have amended that definition to stipulate that the contracts must share in the performance of the same pool of assets as do insurance contracts with a discretionary participation feature. That amendment was intended to restrict the application of the proposed Standard to those that have the features described in paragraph BCA171 so that the risk that entities would structure contracts to achieve a particular accounting outcome would be reduced. The IASB had concluded that there is a greater need to treat investment contracts in the same way as insurance contracts when those contracts participate in the same pool of assets. If that were not the case, then differing treatments could lead to inconsistently reported results for such contracts.

BCA174 Given that investment contracts with a discretionary participation feature always share in the performance of the same pools of assets as insurance contracts with a discretionary participation feature, the IASB had proposed to add the criterion that the contracts must share in the same pool of assets as do such insurance contracts. However, respondents to the 2010 Exposure Draft challenged that assumption. They also raised a concern that including that criterion could lead to accounting arbitrage opportunities because the applicable accounting Standard could depend on how an entity chooses to pool its assets: dividing the pools differently could achieve a desired valuation method that suited the entity better. Accordingly, the IASB proposed to change the criterion to a requirement that investment contracts with a discretionary participation feature within the scope of the proposed Standard must be issued by entities that issue insurance contracts.

BCA175 The IASB considered omitting the criterion that the contracts must share in the performance of the same pool of assets as insurance contracts, and reverting to the IFRS 4 definition. The responses to the 2010 Exposure Draft do not indicate that the IASB needs to take active steps to avoid structuring or address any specific interpretation questions. Nonetheless, the IASB was concerned that, for entities that did not issue insurance contracts, the costs of implementing this Exposure Draft would outweigh the benefits.

BCA176 Because investment contracts with a discretionary participation feature do not transfer significant insurance risk, this Exposure Draft proposes the following modifications to the proposals for insurance contracts (see paragraph 47):

(a) the contract boundary principle for these contracts builds on the defining characteristic, namely, the presence of the discretionary participation features, rather than the existence of insurance risk; and

(b) the proposed requirement for the recognition of the contractual service margin refers to the pattern of the provision of asset management services.

BCA177 The IASB decided that no modifications were necessary to the other requirements of the proposed Standard. In particular, no modifications would be needed for the requirements on separating non-insurance components. This is because:

(a) the investment components of an investment contract with a discretionary participation feature are, in general, highly interrelated with each other, so those investment components would not be distinct. Thus, the entity would not separate any of the investment components from the contract. In the rare cases when the investment component is distinct from the other components, the entity separates the investment component and accounts for it using applicable Standards.

(b) the risks of cash flows from asset management services provided by such contracts are, in general, highly interrelated with the guaranteed benefits, so an entity would generally not separate the goods and services.

Scope exclusions (paragraph 7)

BCA178 The scope of the revised Exposure Draft excludes various items that may meet the definition of insurance contracts, such as:

(a) product warranties that are issued by a manufacturer, dealer or retailer (see paragraphs BCA179–BCA180).

(b) employers' assets and liabilities that arise from employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans (see IAS 19 *Employee Benefits*, IFRS 2 *Share-based Payment* and IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).

(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (see IAS 17 *Leases*, IAS 18 *Revenue* and IAS 38 *Intangible Assets*).

(d) residual value guarantees that are provided by a manufacturer, dealer or retailer and a lessee's residual value guarantee that is embedded in a finance lease (see the 2011 Exposure Draft *Revenue from Contracts with Customers* and the 2013 Exposure Draft *Leases*). However, stand-alone residual value guarantees are not addressed by the IASB's other projects and would remain within the scope of this Exposure Draft.

(e) some fixed-fee service contracts (see paragraphs BCA181–BCA183).

(f) some financial guarantee contracts (see paragraphs BCA184–BCA188).

(g) contingent consideration payable or receivable in a business combination (see IFRS 3).

(h) insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts (see paragraph BCA154).

Product warranties (paragraph 7(a))

BCA179 This Exposure Draft includes the scope exclusion that was previously included in IFRS 4 for product warranties that are issued by a manufacturer, dealer or

retailer. Such warranties cover any defects that were undetected during the manufacture of the product, or provide coverage for the customer for faults that arise after the product is transferred to the customer. They also provide a scope exception for product warranties that qualify as fixed-fee service contracts.

BCA180 Product warranties meet the definition of an insurance contract. However, the IASB proposes to exclude from the scope of the proposed Standard product warranties whose primary purpose is the provision of service. Instead, entities would apply the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers* to those contracts. The IASB notes that entities would generally have applied the premium-allocation approach to such contracts, which would result in accounting similar to that which would result from applying the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*. However, in the IASB's view, the existing practice of accounting for such contracts in the same way as other contracts with customers would provide relevant information for the users of financial statements for the entities that issue such contracts. Changing the existing accounting for these contracts would impose costs and disruption for no significant benefit.

Fixed-fee service contracts (paragraph 7(e))

BCA181 A fixed-fee service contract is a contract in which the level of service depends on an uncertain event. Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. Such contracts meet the definition of an insurance contract because:

(a) it is uncertain whether, or when, assistance or a repair will be needed;

(b) the owner is adversely affected by the occurrence; and

(c) the service provider compensates the owner if assistance or a repair is needed.

BCA182 Fixed-fee service contracts meet the definition of an insurance contract. However, the IASB proposes to exclude from the scope of the proposed Standard fixed-fee service contracts whose primary purpose is the provision of service. Instead, entities would apply the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers* to those contracts. The IASB notes that entities would generally have applied the premium-allocation approach to such contracts, which would result in accounting similar to that which would result from applying the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*. However, in the IASB's view, the existing practice of accounting for contracts in the same way as other contracts with customers would provide relevant information for the users of financial statements for the entities that issue such contracts. Changing the existing accounting for these contracts would impose costs and disruption for no significant benefit.

BCA183 Some respondents to the 2010 Exposure Draft found difficulty in drawing the line between fixed-fee service contracts and insurance contracts, and between different types of fixed-fee service contracts. Some also argued that applying different accounting models to such similar types of contracts could result in a lack of comparability. Nonetheless, for the reasons set out in BCA182, the IASB

confirms that fixed-fee service contracts that have, as their primary purpose, the provision of service will be excluded from the scope of this Exposure Draft. However, the IASB has added clarification to help distinguish fixed-fee service contracts from other types of contracts. In particular, it has set out in paragraph 7(e) the characteristics that would be exhibited by fixed-fee service contracts excluded from the scope of the proposed Standard.

Financial guarantee contracts (paragraph 7(f))

BCA184 IFRS defines a financial guarantee contract as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. These contracts transfer credit risk and may have various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract.

BCA185 Some view all contracts that transfer credit risk as financial instruments. However, a contractual precondition for a payment under the contracts described in paragraph BCA184 is that the holder has suffered a loss—a distinguishing feature of insurance contracts. In the responses to the 2010 Exposure Draft, there were two incompatible views on the appropriate accounting model for financial guarantee contracts:

(a) financial guarantee contracts meet the definition of an insurance contract because the issuer of the contract agrees to compensate the holder when an uncertain future event (ie default) occurs that would adversely affect the holder. Consequently, an entity should account for financial guarantee contracts in the same way as it does for other insurance contracts.

(b) financial guarantee contracts are economically similar to other credit-related contracts within the scope of IFRS 9. Similar accounting should apply to similar contracts. As a result, an entity should account for financial guarantee contracts in the same way as it does for other financial instruments.

BCA186 IFRS 4 currently includes an option that permits an issuer of a financial guarantee contract to account for the contract as an insurance contract if it had previously asserted that it regards the contract as an insurance contract. This option had been intended as a temporary solution, pending the completion of Phase II. However, though the terms of the option may appear imprecise, there is a clear answer in the vast majority of cases and no implementation problems appear to have been identified in practice. The IASB proposes to carry forward, without any substantive changes, that existing option to this Exposure Draft, because it has worked in practice, and results in consistent accounting for economically similar contracts issued by the same entity. The IASB does not view it as a high priority to address the inconsistency that results from accounting for financial guarantee contracts differently depending on the issuer.

BCA187 For some credit-related contracts, it is not a precondition for payment that the holder has suffered a loss. An example of such a contract is one that requires

payments in response to changes in a specified credit rating or credit index. Those contracts are derivatives and do not meet the definition of an insurance contract. These would continue to be accounted for as derivatives.

BCA188 Although current US GAAP requires issuers of most guarantees that are not accounted for as financial guarantee insurance to recognise them initially at fair value, that requirement has the following scope exceptions:

(a) a guarantee issued either between parents and their subsidiaries or between corporations under common control;

(b) a parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual); or

(c) a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

The FASB's Exposure Draft proposes that these scope exceptions for related party guarantees should be limited to circumstances in which the entity does not issue similar guarantees to third parties or on debt owed by third parties. In finalising *Financial Guarantee Contracts* (Amendments to IAS 39 and IFRS 4) in August 2005 the IASB decided not to introduce such exemptions into IFRS and it does not propose one now. The IASB believes that failing to account for liabilities under such guarantees would not provide a faithful representation of the issuer's financial position.

Separating components from an insurance contract (paragraphs 9–11 and B31–B35)

BCA189 As discussed in paragraph BC7, insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows and cash outflows. Some insurance contracts may:

(a) contain embedded derivatives that, if bifurcated, would be within the scope of IFRS 9;

(b) provide goods and non-insurance services that, if provided under separate contracts, would be within the scope of the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*; or

(c) contain investment components that, if they were separate contracts, would be within the scope of IFRS 9.

BCA190 Separating such non-insurance components from an insurance contract can improve transparency. This is because accounting for such components using other applicable Standards makes them more comparable to similar contracts that are issued as separate contracts, and allows users of financial statements to better compare the risks undertaken by entities in different businesses or industries.

BCA191 However, separating components also has limitations. Insurance contracts contain a bundle of interdependent rights and obligations. Separating a single contract into components could result in complex and uninformative accounting when the cash flows attributable to the components are interdependent. Furthermore, when cash flows are interdependent, separating

the cash flows for each component can be arbitrary, particularly if the contract includes cross-subsidies between components or discounts.

BCA192 The 2010 Exposure Draft proposed that an entity should separate (unbundle) a component that is not closely related to the insurance coverage specified in the contract, and identified some common examples of components that are not 'closely related' to the insurance coverage. The term 'closely related' is used in IAS 39 and IFRS 9 in the criteria that determine whether embedded derivatives must be bifurcated. However, the responses to the 2010 Exposure Draft indicated that some were unsure how to interpret 'closely related' for non-insurance components embedded in insurance contracts. This Exposure Draft clarifies the principles from the 2010 Exposure Draft by relying on notions developed in the 2011 Exposure Draft *Revenue from Contracts with Customers*.

BCA193 This Exposure Draft proposes requirements for the separation of the following non-insurance components:

(a) embedded derivatives (see paragraphs BCA195–BCA199);

(b) goods and non-insurance services (see paragraphs BCA200–BCA203); and

(c) investment components (see paragraphs BCA204–BCA207).

BCA194 The proposed criteria for separating the different types of non-insurance components from insurance components differ to reflect the different nature of those components. This is consistent with applying different accounting models to the equivalent contracts accounted for on a stand-alone basis.

Embedded derivatives (paragraph 10(a))

BCA195 IAS 39 and IFRS 9 require entities to account separately for some derivatives embedded in hybrid contracts. In issuing this Exposure Draft, the IASB notes that accounting separately for some embedded derivatives in hybrid contracts:

(a) ensures that contractual rights and obligations that create similar risk exposures are treated in the same way whether or not they are embedded in a non-derivative host contract that is not itself measured at fair value through profit or loss; and

(b) counters the possibility that entities might seek to avoid the requirement to measure derivatives at fair value by embedding a derivative in a non-derivative host contract. In the IASB's view, fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient transparency in the financial statements. If derivatives were measured at cost their role in reducing or increasing risk would not be visible. In addition, the value of derivatives often changes disproportionately in response to market movements and fair value is the measurement basis that best captures non-linear responses to changes in risk. That information is essential to communicate the nature of the rights and obligations inherent in derivatives to users of financial statements.

BCA196 IFRS 4 confirmed that the requirements of IAS 39 for embedded derivatives would apply to those that are embedded in insurance contracts and the IASB largely reconfirmed those requirements when developing the 2010 Exposure Draft, with some changes:

(a) IFRS 4 does not require entities to separate embedded derivatives that meet the definition of an insurance contract because it would be contradictory to require a fair value measurement of an insurance contract that is embedded in a larger contract when such a measurement is not required for a stand-alone insurance contract;

(b) IFRS 4 does not require the separation of an embedded derivative from the host contract if they are so interdependent that an entity cannot measure the embedded derivative separately;

(c) the 2010 Exposure Draft proposed to prohibit the separation of embedded derivatives that are not 'closely related', which IFRS 4 permits entities to unbundle; and

(d) the 2010 Exposure Draft proposed to remove the exception in IFRS 4 that an entity need not separate specified surrender options in an insurance contract. Instead, the entity would apply the requirements in IAS 39 to decide whether it needs to bifurcate a surrender option.

BCA197 Some respondents to the 2010 Exposure Draft suggested that separating non-insurance components from insurance contracts introduces excessive complexity with little additional benefit. They believe that measuring embedded derivatives at fair value would not be materially different from measuring them by applying the current value measurement requirements proposed for insurance contracts in this Exposure Draft.

BCA198 When embedded derivatives are closely related to the host insurance contract, the IASB agrees that the benefits of separating those embedded derivatives do not outweigh the costs. However, the IASB believes that those benefits would exceed the costs when the embedded derivatives are not closely related to the host insurance contract. Existing practice indicates that the costs of separating such embedded derivatives from host insurance contracts would not be excessive.

BCA199 This Exposure Draft does not propose that entities should bifurcate embedded derivatives that meet the definition of an insurance contract. The IASB concluded that it would be inconsistent to measure some insurance contracts at fair value because they are embedded derivatives and to measure other insurance contracts in accordance with the proposals in this Exposure Draft.

Goods and non-insurance services (paragraphs 10(c), 11 and B33–B35)

BCA200 If unbundled, obligations to provide goods and services would be accounted for using the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*. That Exposure Draft proposes principles for identifying separate performance obligations in a contract with a customer. The IASB believes that, regardless of whether the host contract is within the scope of this Exposure Draft or of the 2011 Exposure Draft *Revenue from Contracts with Customers*, an entity

should use similar principles to separate performance obligations to provide non-insurance goods and services from the host contract. Accordingly, this Exposure Draft proposes that entities should unbundle only goods and services that are distinct from the provision of insurance coverage. That is the case when:

(a) the entity regularly sells the good or service separately; or

(b) the policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder.

BCA201 This Exposure Draft proposes that an entity should allocate the cash inflows of an insurance contract between the host insurance contract and the distinct good or non-insurance service, based on the stand-alone selling price of the components. In the IASB's view, in most cases entities would be able to determine an observable stand-alone selling price for the goods or services bundled in an insurance contract if those components meet the criteria set out above for separation.

BCA202 However, in some cases the stand-alone selling price may not be directly observable because the entity does not sell the insurance and the goods or services components separately, or if the consideration charged for the two components together differs from the stand-alone selling prices because the entity charges more or less for the bundled contract than the sum of the prices for each component, or because there are cross-subsidies. In those cases an entity would need to estimate the stand-alone selling prices of each component in order to allocate the transaction price. Consistently with the approach in the 2011 Exposure Draft *Revenue from Contracts with Customers*, such discounts and cross-subsidies would be allocated to one or both components on the basis of observable evidence. In the IASB's view, this approach ensures that the allocation of cross-subsidies and discounts/supplements would faithfully represent the economics of the unbundled components.

BCA203 This Exposure Draft proposes that cash outflows should be allocated to the component that they relate to, and that cash outflows that do not clearly relate to one of the components should be allocated between components on a consistent and rational basis. Cash outflows that do not clearly relate to one of the components include acquisition costs and some fulfilment cash flows relating to overhead costs. That approach is consistent with the requirements in this Exposure Draft for allocating those acquisition and fulfilment costs that cover more than one portfolio to the individual portfolios, and is also consistent with the requirements in other Standards for allocating the costs of production, for example, the 2011 Exposure Draft *Revenue from Contracts with Customers* and IAS 2 *Inventories*.

Investment components (paragraphs 10(b), 11 and B31–B32)

BCA204 An investment component is an amount that the contract requires the entity to repay to the policyholder even if an insured event does not occur. Because the policyholder must generally pay premiums in advance, many insurance

contracts have an implicit or explicit investment component that would, if it were a separate financial instrument, be within the scope of IFRS 9.

BCA205 Entities do not present investments and repayments of investments as revenue for financial instruments within the scope of IFRS 9. The IASB believes that the presentation of insurance contract revenue with implicit and explicit investment components would not faithfully represent the similarities between financial instruments within the scope of IFRS 9 and those investment components. Accordingly, the IASB considered whether entities should separate those investment components from insurance contracts and account for them by applying IFRS 9.

BCA206 However, the cash outflows for the investment and insurance components are often highly interrelated, especially when the investment component is implicit. The IASB concluded that, while it might be possible to separate some explicit investment components, it would be complex, subjective and arbitrary to separate many implicit account balances and account for them by applying IFRS 9. Accordingly, this Exposure Draft proposes that an entity should:

(a) not separate investment components from insurance contracts, unless the investment component is distinct. An investment component is distinct if the cash flows of the insurance contract are not highly interrelated with the cash flows from the insurance component.

(b) account for all investment components that have cash flows that are interrelated with the insurance contract by applying the proposals in this Exposure Draft, but eliminate any investment components from insurance contract revenue and expense that is reported in accordance with paragraphs 56–59 of this Exposure Draft.

BCA207 This Exposure Draft proposes that the cash flows that are allocated to a separated investment component should be measured on a stand-alone basis as if the entity had issued that investment contract separately. This conclusion is consistent with the objective of separation, which is to account for an unbundled component in the same way as for stand-alone contracts with similar characteristics. The IASB believes that entities would be able to measure the stand-alone value for an investment component by applying IFRS 9 in all cases.

Prohibition on separating components when not required (paragraph 10(d))

BCA208 The IASB considered whether to permit an entity to separate a non-insurance component when not required by this Exposure Draft. Some argue that entities should be permitted to unbundle particular investment components, such as policy loans, that they had unbundled when applying their previous accounting policies, even if those components have cash flows interrelated with those of the host insurance contract. However, the IASB concluded that it would not be possible to separate in a non-arbitrary way a component that is not distinct from the insurance contract. Permitting an entity to separate such components would mean that the entity measures the components in the contract on an arbitrary basis. That would reduce the transparency and comparability of the financial statements.

Recognition, modification and derecognition (paragraphs 12–16 and 49–53)

Recognition (paragraphs 12–16)

BCA209 The 2010 Exposure Draft proposed that an entity should recognise the obligations and associated benefits arising from an insurance contract from the time at which it accepts risk. This proposal differed from that proposed for revenue contracts within the scope of the 2011 Exposure Draft *Revenue from Contracts with Customers*. The difference is explained by the differences in the overall accounting models. The accounting model for revenue contracts focuses on measuring performance. So, consistently with that model, an entity recognises no rights or obligations until one party has performed under the contract. In contrast, the accounting model proposed for insurance contracts focuses on measuring the obligations accepted by the entity. So, consistently with that model, the entity recognises its obligations as soon as they arise.

BCA210 However, respondents to the 2010 Exposure Draft were concerned that the requirement to recognise the insurance contract from the time at which the entity accepts risk means that the contract needs to be tracked and accounted for even before the coverage period begins. Those respondents stated that accounting for the contract before the coverage period begins would require system changes whose high costs outweigh the benefits of doing so, particularly because the amount recognised before the coverage period begins might be immaterial, or even nil. In their view, even if amounts recognised before the coverage period begins are insignificant, requiring an entity to account for contracts in the pre-coverage period would impose on the entity the requirement to track contracts to demonstrate that the amounts are insignificant.

BCA211 The IASB was sympathetic to those concerns and considered the following possible solutions:

(a) accounting for an insurance contract before the start of the coverage period in the same way as for an executory contract. This would mean that the entity would not recognise the contract until one party starts to fulfil its obligations under the contract. However, although in most cases there would be no significant assets and liabilities between signing the contract and the start of the coverage period, an entity would need to account for any changes in circumstances that make the contract onerous. As a result, accounting for the insurance contract in the same way as for an executory contract would not address the operational concerns raised by respondents to the 2010 Exposure Draft.

(b) accounting for an insurance contract before the start of the coverage period in the same way as for a forward contract (a derivative). However, this approach would still require the tracking of policies in the pre-coverage period and would provide little benefit, because the value of the forward contract would still be difficult and costly to measure.

(c) recognising the insurance contract from the beginning of the coverage period. The IASB noted that, for some contracts, the coverage period might not begin for many years, even though the issuing entity assumes significant insurance risk before coverage begins. For example, in a deferred annuity contract with a guaranteed annuitisation option, the insured event would arise only after the annuitisation option has been exercised. Nonetheless, the IASB believes that offering a guaranteed annuitisation option creates insurance risk. Consequently, the IASB believes that failing to recognise such contracts before the annuitisation option is exercised would omit useful information about such contracts from the financial statements.

BCA212 Accordingly, the IASB believes that entities should recognise insurance contracts from the earliest of:

(a) the beginning of the coverage period;

(b) the date on which the first payment from the policyholder becomes due; or

(c) if applicable, the date on which facts and circumstances indicate that the portfolio of insurance contracts to which the contract will belong is onerous.

BCA213 Typically, the first premium is due at the start of the coverage period and the entity recognises the insurance contract at that point. In the IASB's view:

(a) the rationale described in paragraph BCA210 for not recognising a contract in the pre-coverage period—ie tracking information before the coverage period begins does not generate benefits that outweigh costs—does not apply to contracts after payments have been received; and

(b) the benefits of reporting insurance contracts that are onerous in the pre-coverage period outweigh the costs of recognising the contract.

Accounting in the pre-coverage period (paragraphs 13 and 15)

BCA214 In some cases, changes in circumstances make an insurance contract onerous before coverage begins. The IASB believes that entities should recognise such onerous contracts in the pre-coverage period. However, consistently with the IASB's decisions described in paragraph BCA212, this Exposure Draft proposes that onerous contracts should be recognised only when facts and circumstances indicate that a portfolio of insurance contracts is onerous. That approach would ensure that entities recognise adverse changes in circumstances without the need to track contracts individually before the coverage period begins. Instead, entities could undertake high-level reviews of portfolios of contracts to identify portfolios of pre-coverage obligations that are onerous.

BCA215 The costs of originating insurance contracts are often incurred before the coverage period begins. This Exposure Draft proposes that such costs should be recognised as part of the cost of the portfolio of contracts that will contain the contract once a contract qualifies for initial recognition. The IASB observes that, in effect, entities would recognise contracts from the date that the acquisition

costs are incurred. However, entities would not need to update assumptions and would determine the contractual service margin from the date when the contract qualifies for initial recognition.

Modifications (paragraphs 49 and 52–53)

BCA216 Paragraph B25 of this Exposure Draft states that a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished. An obligation is extinguished when it has been discharged or cancelled or has expired. However, in some cases, an entity may modify the terms of an existing contract in a way that significantly changes the economics of the contract. This Exposure Draft specifies requirements both for modifications that significantly change the economics of the contract and for those that do not.

Modifications that change the nature of the contract (paragraph 49(a))

BCA217 When an existing contract is derecognised and a new contract based on the modified terms is recognised, this Exposure Draft proposes that the consideration for the new contract is deemed to be the price that the entity would have charged the policyholder if it had entered into a contract with equivalent terms at the date of the actual modification. That deemed consideration determines:

(a) the gain or loss on derecognition of the existing contract; and

(b) the amount of the contractual service margin for the new contract.

BCA218 The IASB considered the view that the implicit premium should be the fair value of the existing contract before modification, because it would be less subjective than a hypothetical price. The fair value of the consideration is also used to measure the gains and losses for the extinguishment of financial liabilities and most other extinguishments. As a result, the gain or loss on the derecognition of the existing contract would be consistent with the accounting for other extinguishments.

BCA219 However, the IASB noted that at the date of modification, the fair value of a contract with the equivalent terms is not observable. Thus, the fair value would not be determined on the basis of observable market information and would be measured using Level 3 of the fair value hierarchy (see IFRS 13). As a result, fair value would also be subjective. Furthermore, the IASB concluded that the use of fair value would impair the comparability between the measurement of the amended insurance contract and the measurement of an insurance contract that has not been amended. Accordingly, the IASB proposes that modifications to contracts that trigger derecognition should be measured using the premium that the entity would have charged if it had entered into a contract with equivalent terms at the date of the contract modification. Such an approach would measure the modified contract in a way that is consistent with the measurement of other insurance contract liabilities. That amount would differ from fair value as follows:

(a) it uses entity-specific assumptions for some inputs, including the degree of risk aversion, whereas fair value uses market participant assumptions in all cases;

(b) it excludes the entity's own non-performance risk, whereas fair value would include the entity's own non-performance risk; and

(c) it includes a contractual service margin, whereas fair value includes no such margin, although fair value implicitly includes a current value for any additional margin that market participants would require.

Additional benefits (paragraph 49(b)(i))

BCA220 Some insurance contract modifications provide policyholders with additional benefits—often for an additional premium. This Exposure Draft proposes that a contract that has been modified as such should be treated as a new insurance contract with no effect on the measurement of the original contract. Accordingly, the entity would determine the contractual service margin for the new contract by reference to the additional premium charged.

BCA221 One consequence of this approach is that an entity would recognise a loss in the period of the modification if the additional premium charged is lower than the cash outflows that are related to the expected additional benefits. If the modification was treated as a change in estimates of cash flows, such changes would reduce the contractual service margin and the loss would be recognised over the remaining coverage period. The IASB decided instead to propose treating such modifications as new insurance contracts. This would result in symmetrical accounting for contract modifications that eliminate rights and obligations and for contract modifications that add rights and obligations. This reduces the potential for accounting arbitrage through contract modification.

Reduction of benefits (paragraph 49(b)(ii))

BCA222 This Exposure Draft carries forward the proposal from the 2010 Exposure Draft that an entity should derecognise an insurance contract liability, or part of an insurance contract liability, from its statement of financial position only when it is extinguished. This occurs when the obligation specified in the insurance contract is discharged or cancelled or expires. This proposal is consistent with the requirements in IFRS and with the derecognition requirements for financial liabilities in IAS 39 and IFRS 9. It also provides symmetrical treatment for the recognition and derecognition of insurance contracts.

BCA223 The IASB considered concerns that an entity might not know whether a liability has been extinguished because claims are sometimes reported years after the end of the coverage period. It also considered concerns that an entity might be unable to derecognise those contracts. Respondents believe that, in some cases, this would result in accounting that is unreasonable and unduly burdensome. However, in the IASB's view, ignoring contractual obligations that remain in existence and that can generate valid claims would not be a faithful representation of an entity's financial position. In addition, the IASB expects that when there is no information to suggest that there are unasserted claims on the insurance contract liability for an expired contract, the insurance contract liability would be measured at a very low amount. Accordingly, there may be

little practical difference between recognising an insurance liability measured at a very low amount and derecognising the liability.

Presentation

Statement of financial position (paragraphs 54–55)

BCA224 This Exposure Draft proposes that the combination of rights and obligations arising from an insurance contract should be presented as a single insurance contract asset or liability in the statement of financial position. This is consistent with the measurement of an insurance contract asset or liability as a package of cash inflows and cash outflows. It is also consistent with the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*, which treat the combination of rights and obligations from a contract with a customer as though they give rise to a single contract asset or liability.

BCA225 IAS 1 specifies the line items that are required to be presented in the statement of financial position. Although those line items do not include insurance or reinsurance contracts, the IASB believes that such contracts are sufficiently distinct to warrant separate presentation in the statement of financial position.

BCA226 Consistently with the IASB's view that a reinsurance contract is separate from the underlying insurance contract, this Exposure Draft states that an entity should not offset reinsurance assets against related insurance liabilities. IAS 32 establishes a principle to determine when an entity should offset a financial liability against a financial asset. Reinsurance assets would rarely, if ever, meet the criteria for applying that principle.

Disclosure (paragraphs 69–95)

BCA227 The IASB proposes that an entity should disclose information to enable users of financial statements to understand the amount, timing and uncertainty of future cash flows that arise from contracts within the scope of the proposed Standard. This principle is supplemented with some specific disclosure requirements designed to help the entity satisfy that principle. By specifying a disclosure principle, the IASB hopes to eliminate detailed and prescriptive disclosure requirements about the various types of insurance contracts. In situations in which the information provided to meet the specific disclosures is not sufficient to meet that principle, paragraph 70 of this Exposure Draft proposes to require the entity to disclose additional information that is necessary to meet that principle.

BCA228 The IASB used the disclosure requirements in IFRS 4, including the disclosure requirements in IFRS 7 that are incorporated in IFRS 4 by cross-reference, as a basis for its proposals. In addition, the IASB proposes that entities should disclose the following items:

(a) information about the amounts recognised, including reconciliations of:

(i) changes in insurance contract liabilities and assets, analysed to provide information about the measurement model (see paragraphs 74–75); and

(ii) changes in insurance contract liabilities and assets, analysed to provide information about the determination of insurance contract revenue (see paragraph 76).

These reconciliations are discussed in paragraphs BC80–BC85.

(b) information about the amounts in the financial statements relating to contracts with cash flows that specify a link to returns on underlying items (see paragraphs 80 and BC54).

(c) information about the inputs used in measuring insurance contract revenue (see paragraphs 81(a) and BC80–BC85).

(d) information about the initial recognition of insurance contracts in the statement of financial position (see paragraphs 81(b) and BC86–BC89).

(e) an explanation of methods, inputs and processes used in the measurement and the effects of changes in those methods, inputs and processes (see paragraph 83). Because the proposed measurement for insurance contracts is a current measure of items that are unlikely to be observable, the transparency of the inputs and methods used and the effect of any changes are important to users of the financial statements.

(f) a translation of the risk adjustments into a confidence level for disclosure, even if the entity had not used that technique to determine the risk adjustment (see paragraphs 84 and BCA100–BCA102). That disclosure would enhance comparability among entities that issue insurance contracts.

(g) information about the yield curves used to discount cash flows that do not depend on the performance of specified assets (see paragraphs 85 and BCA83).

(h) information about the nature and extent of risks arising from insurance contracts, including the effect of the regulatory framework in which the entity operates (see paragraphs 86–95 and BCA230–BCA232).

Disclosures that the IASB considered but did not include in this Exposure Draft

Measurement uncertainty analysis

BCA229 The 2010 Exposure Draft proposed the disclosure of an analysis of the measurement uncertainty in the inputs that have a material effect on the measurement. This would have been similar to the disclosure for unobservable inputs in fair value measurement, as described in paragraphs BC202–BC210 of the Basis for Conclusions to IFRS 13. The IASB had decided not to require such a disclosure for unobservable inputs in IFRS 13 because of concerns about costs relative to benefits, but instead required more quantitative information about the inputs as well as narrative information about how those inputs influence the measurement (as described in paragraphs BC188–BC195 and BC206 of IFRS 13 and in paragraphs BC80–BC85 of this Exposure Draft). Accordingly, consistently with its decision for IFRS 13, the IASB did not include such a disclosure in this Exposure Draft.

Regulatory capital

BCA230 The 2010 Exposure Draft proposed that an entity should disclose the effect of the regulatory frameworks in which the entity operates, for example, minimum capital requirements or required interest rate guarantees. In their responses to the 2010 Exposure Draft, many users of financial statements indicated a desire for additional disclosures that would help them to understand and analyse those effects, in particular:

(a) information about how much regulatory capital an entity will need to hold for the new contracts written in the period, and when that capital will cease to be required; and

(b) information about the amount of equity generated in a reporting period that is not needed to service the regulatory capital requirements. That amount is sometimes referred to as 'free cash flow'.

BCA231 Disclosure of the regulatory capital required could provide users of financial statements with information about:

(a) the entity's profitability, ongoing capital needs and, thus, financial flexibility;

(b) an entity's capacity to write new business in future periods, because the excess over regulatory capital held is available to support future new business; and

(c) improved understanding of the financial position, financial performance and cash flows during the reporting period.

BCA232 However, such disclosures do not arise only for insurance contracts, but could be useful for all entities operating in a regulated environment. The IASB was concerned about developing such disclosures in isolation in a project on accounting for insurance contracts, and believes that a better approach would be to develop such disclosures as part of other work that it may undertake on disclosures more generally.

Appendix B
Effect Analysis

EA1 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely ongoing application costs and benefits of those requirements—these costs and benefits are collectively referred to as 'effects'. The IASB gains insight on the likely effects of proposed new requirements through its formal exposure of the proposals and through its fieldwork, analysis and consultations with relevant parties through outreach activities. The likely effects are assessed:

(a) in the light of the IASB's objective of financial reporting transparency; and

(b) in comparison to the existing financial reporting requirements.

EA2 The proposed requirements would replace IFRS 4 *Insurance Contracts*. IFRS 4 is an interim Standard that permits a wide range of practices in the accounting for insurance contracts and includes a 'temporary exemption' from other Standards, and from the requirement to consider the *Conceptual Framework* in selecting accounting policies for insurance contracts. Accordingly, the new Standard on insurance contracts is expected to improve the comparability of financial statements for entities that issue insurance contracts and the relevance and reliability of information about insurance contracts.

EA3 In that context, the paragraphs that follow discuss the evaluation of the likely effects of the proposed requirements, including:

(a) whether the proposed changes are likely to affect how activities are reported in the financial statements of those applying IFRS (see paragraphs EA5–EA9);

(b) whether those changes improve the comparability of financial statements between different reporting periods for an individual entity and between different entities in a particular reporting period (see paragraphs EA10–EA11);

(c) whether the changes will improve the ability of the users of financial statements to assess the future cash flows of an entity (see paragraphs EA12–EA15);

(d) whether the improvements to financial reporting will result in better economic decision-making (see paragraph EA16–EA18);

(e) the likely effect on compliance costs for preparers, both on initial application and on an ongoing basis (see paragraph EA19–EA22); and

(f) the likely costs of analysis for users of financial statements, including the costs of extracting data, identifying how the data has been measured and adjusting data for the purposes of including them in, for example, a valuation model (see paragraph EA23–EA24).

EA4 The analysis of these effects (the 'effect analysis') considers their impact, but it cannot quantify the magnitude of that impact.

How proposed changes affect how activities are reported

EA5 Insurance contracts are generally issued by regulated insurance companies; hence, the forthcoming Standard is likely to affect entities primarily in that industry. At present, insurance contracts are accounted for using different accounting models that have evolved according to the circumstances in each jurisdiction to address the products most prevalent in that jurisdiction. Applying the proposals in different jurisdictions would require entities to make different system changes, or gather new information, depending on the entity's existing accounting practices. Those activities may require significant time, effort and costs, but those costs will vary for different entities in different jurisdictions. Thus, the impact of the proposals on an entity's financial reporting will depend on the types and nature of the insurance contracts that an entity issues, and on the accounting and regulatory requirements that are currently being applied.

EA6 The proposals would measure an insurance contract on the basis of current market information. Consequently, the magnitude of the impact on an entity's financial statements also will be affected by the prevalent economic conditions at the time of implementation.

EA7 Because current requirements typically differentiate between non-life insurance contracts, such as property and casualty contracts, and life contracts, such as term life or endowments, paragraphs EA8–EA9 highlight how the proposals in this Exposure Draft will affect each of those types of contracts.

Non-life insurance contracts

EA8 In general, there will be relatively little change for the accounting for many non-life insurance contracts. The main changes for non-life insurance contracts include:

(a) the introduction of discounting and a risk adjustment when measuring the liability for incurred claims;

(b) excluding the investment component from the revenue that is recognised in the statement of profit or loss and other comprehensive income;

(c) an increase in the information in the financial statements about claims liabilities, changes in risk and the effects of discounting; and

(d) measuring onerous contracts on an expected value basis that takes into account all of the available information, rather than on a most likely basis or an incurred claims basis.

Life insurance contracts

EA9 There is greater divergence between the accounting models applied today for life insurance contracts than there is between the accounting models applied to non-life insurance contracts. The following table summarises the changes that may result from this Exposure Draft.

Current requirements	Revised Exposure Draft requirements
Applicability	
Most national accounting requirements (national GAAPs) address the financial reporting of insurance entities. In addition, requirements may differ depending on the type of life insurance product issued.	This Exposure Draft addresses the treatment of insurance contracts. The principles apply to all life and non-life insurance, and to some contracts with similar economics.
Investment components	
Some national GAAPs require some investment components (ie explicit account balances) embedded in an insurance contract to be separated and measured as financial instruments. Similarly, some national GAAPs requires some services to be separated and accounted for in accordance with revenue recognition requirements. In contrast, some national GAAPs require the whole insurance contract to be measured as a bundle of rights and obligations.	This Exposure Draft proposes that all non-insurance components should be separated from insurance contracts when they are distinct from the insurance component in an insurance contract.
Current estimates	
The majority of national GAAPs use estimates that are wholly, or partially, locked-in at contract inception. Typically, some or all of these assumptions will be updated in specified circumstances, for example, when the contracts are deemed onerous. A few jurisdictions require current estimates only for specified products.	This Exposure Draft uses current estimates to reflect the most up to date information available. In addition, this Exposure Draft is likely to require disclosure of more information about assumptions and the effects of assumptions than is currently provided.

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Current requirements	Revised Exposure Draft requirements
Discount rates	
Some national GAAPs discount the cash flows from an insurance contract using a discount rate that is based on the expected return of the assets backing the insurance liabilities. A few use the risk-free discount rate.	This Exposure Draft proposes that entities discount the cash flows from an insurance contract using a discount rate that reflects only the characteristics of the insurance liability, and not the characteristics of the assets backing that liability. Thus the resulting measurement of the liability would not be reduced by expected investment spreads.
Risk adjustment	This Exposure Draft proposes that entities include an explicit, current risk adjustment in the measurement of insurance contracts. This Exposure Draft also proposes disclosures about risks and the determination of the risk adjustment to increase comparability between entities.
The approach to risk differs between jurisdictions: • some national GAAPs require an explicit or, more commonly, an implicit risk adjustment; • some use a risk adjustment for regulatory reporting only; • some do not use a risk adjustment for either financial reporting or regulatory reporting; and • some use a risk adjustment for some contract types but not for others.	

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Current requirements	Revised Exposure Draft requirements
Options and guarantees	
Many national GAAPs account for some, but typically not all, options and guarantees embedded in insurance contracts. Treatments vary: • in some cases, embedded options and guarantees are not recognised until they come into the money, or even later (ie the measurement reflects only their intrinsic value); • in other cases, the measurement reflects not only their intrinsic value, but also their time value (ie the possibility that they may come into the money); and • in some cases, measurements are at fair value, while in other cases measurements are at management's estimate of the most likely outcome.	This Exposure Draft proposes that entities measure embedded options and guarantees using a current value approach that incorporates all of the available information. That approach reflects both the time value and the intrinsic value of embedded options and guarantees.
Acquisition costs	
Most national GAAPs require entities to recognise a deferred acquisition cost asset. Consequently, most national GAAPs specify complex and hard-to-understand mechanisms for dealing with that deferral and in assessing impairment. Some national GAAPs require entities to recognise all acquisition costs as an expense when they are incurred.	This Exposure Draft proposes to include in the measurement of the insurance contract all directly attributable fulfilment costs, including acquisition costs. There is no recognition of an asset that represents the acquisition of the insurance contract. The proposals ensure that any lack of recoverability of the acquisition costs is reflected in the measurement of the insurance contract, avoiding the need for complex deferral and impairment mechanisms.

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Current requirements	Revised Exposure Draft requirements
Revenue	
Most national GAAPs present in profit or loss the premium received or to be received, and the corresponding claims expense, other than for contracts with explicit account balances. The premiums are reported on a basis that is inconsistent with those reported for non-life insurance contracts and all other industries.	This Exposure Draft proposes that insurance contract revenue and the corresponding claims and expenses will be reported as the entity provides services under the contract. Insurance contract revenue would exclude investment components. This is broadly consistent with the principles that are used to guide what revenue is reported for short-term insurance contracts and all other industries.
Profit recognition	
For life insurance, national GAAPs typically recognise profits over the life of the contract according to the drivers of profit that vary by country and product.	This Exposure Draft proposes that the drivers of profit would arise from: • the contractual service margin, which is recognised as the entity provides services over the coverage period; and • the risk adjustment, which is recognised as the entity is releases from risk over the coverage and settlement period.

Improved comparability of financial information

EA10 As noted in paragraph EA2, substantial differences occur in the way in which different entities account for insurance contracts between jurisdictions.

EA11 In addition, existing accounting requirements for insurance contracts in many jurisdictions result in financial information that cannot be easily compared to the information produced by the entities in other industries or that does not allow comparison between different types of insurance contracts. Many existing requirements reflect a specific consideration of individual products, considered in isolation from the general financial reporting community. In contrast, the proposals in this Exposure Draft would apply commonly understood principles to many aspects of the accounting for insurance contracts. Accordingly, the proposals in this Exposure Draft for insurance contracts would:

(a) eliminate much of the diversity in practice, both for similar contracts issued by different entities and for different types of insurance contracts with similar economic features; and

(b) improve comparability between the accounting for insurance contracts and the accounting for other types of contracts by reducing the differences between the requirements for insurance contracts and those for other transactions, except for differences that more faithfully represent the economics of the transaction.

Improved financial information for assessing the timing, amount and uncertainty of cash flows

EA12 This Exposure Draft proposes to:

(a) introduce a comprehensive, coherent framework that provides information that reflects the many different ways in which entities make money from insurance contracts, whether through fees from asset management services, investment income from a spread business or underwriting profit from a protection business. An advantage of a comprehensive, coherent framework for all insurance contracts is that, depending on what features are significant to any given contract at any given time, the measurement of the insurance contract reflects those features as appropriate, without creating the discontinuities that would occur if different models were used to reflect the different features.

(b) measure insurance contracts in a way that uses updated estimates and assumptions, using market-consistent information where available, and that reflects the time value of money and uncertainty relating to the insurance contract. The use of a current value measurement model for the insurance contracts liability is necessary for two important reasons:

(i) it provides transparent reporting of changes in the insurance contract liability and complete information about changes in estimates; and

(ii) it results in the transparent reporting of the economic value of options and guarantees embedded in insurance contracts.

EA13 In the IASB's view, those changes will improve the usefulness of the financial statements for assessing the amount, timing and uncertainty of cash flows.

EA14 The IASB acknowledges that usefulness of the information about insurance contracts may be limited by the subjectivity in the estimates and judgements that are required to measure the amounts reported in the financial statements. Nonetheless, the IASB believes that such subjectivity is unavoidable. Insurance contracts are, by definition, exposed to significant risks and uncertainties that are difficult to quantify. Assessing and measuring those effects requires the use of judgement.

EA15 To mitigate the effects of subjectivity in those estimates and judgements, this Exposure Draft proposes disclosures that will, for example, require entities:

(a) to identify the inputs, methods, techniques and judgements applied;

(b) to help users of financial statements assess the impact of those inputs, methods, techniques and judgements on the measurement of the insurance contract; and

(c) to explain the reasons for any changes in those inputs, methods, techniques or judgements.

Information for better economic decision-making

EA16 In most jurisdictions, there is a significant barrier to understanding the financial position and performance of entities issuing insurance contracts. The inherent difficulties of accounting for long-dated, highly uncertain obligations has been exacerbated by industry practices that have developed in isolation and have generally not been reviewed as a whole for consistency. In addition, existing accounting requirements sometimes only use information that reflects the entity's expectations when it entered into contracts, possibly decades previously, and may not report complete information about insurance contracts in a way that highlights economic mismatches between those contracts and assets that the entity holds. Some accounting requirements were developed many years ago and have not been updated to address the changing needs of the users of financial statements, to deal with new products that have been developed, or to take advantage of new techniques to estimate uncertain obligations.

EA17 The IASB proposes that entities should provide current, updated information about the effect of insurance contracts on an entity's financial position. It believes that such information would enable users of financial statements to make better economic decisions because they provide transparency about the risks from, and variability of, obligations arising from insurance contracts. Furthermore, the IASB proposes that an entity would account for insurance contracts separately from the assets and liabilities that it holds. The IASB believes that this would result in financial statements that depict the success or failure of the entity's asset-liability practices.

EA18 The IASB's proposals are not intended to be consistent with the requirements of regulatory frameworks. The primary objectives of many regulatory frameworks are to protect consumers, ensure availability of insurance products and to support economic stability rather than to provide useful information to users of financial statements. Nonetheless, some of the amounts reported in accordance with IFRS support regulatory objectives, and IFRS reporting has effects for regulated entities, for example, those that issue insurance contracts. Because different regulators use different frameworks in different jurisdictions, there will be different effects in different jurisdictions and it is impossible to quantify the magnitude of those effects.

The likely effect on compliance costs for preparers

EA19 The IASB expects significant compliance costs for preparers both on initial application and on an ongoing basis. The amount of cost would depend significantly on the extent to which the proposed requirements differ from the existing requirements.

EA20 On initial application, many entities will need to modify existing systems in order to obtain the information needed to apply the proposals in this Exposure Draft. However, the costs of modifying existing systems will vary depending on the type of information currently collected and produced for management, prudential or financial reporting purposes. The entities that will be most affected are those that currently do not collect similar information. Entities that already prepare market-consistent information, even if not for financial reporting purposes, will have fewer costs in implementing the proposals in this Exposure Draft. Similarly, those entities in jurisdictions that are in the process of implementing new requirements for regulatory purposes will be considering an overhaul of existing systems. Such entities may have fewer costs if they can implement new financial reporting and new regulatory requirements at (or near) the same time.

EA21 While the costs associated with the estimation requirements on an ongoing basis will be less than on initial application, they remain significant. Respondents to the 2010 Exposure Draft and the 2007 Discussion Paper indicated that the overall approach was broadly supported. However, in response to the feedback received on the 2010 Exposure Draft, the IASB has developed its proposals so that entities would:

(a) offset changes in estimates about future services in the contractual service margin;

(b) recognise the effects of changes in discount rates in other comprehensive income;

(c) measure and present the fulfilment cash flows that are expected to vary directly with returns on underlying items on the same basis as those underlying items, provided that the contract requires the entity to hold underlying items and specifies a link to returns on those underlying items; and

(d) present insurance contract revenue and expense.

These proposals may make the ongoing costs of compliance greater than the ongoing costs that would have been required to comply with the proposals in the 2010 Exposure Draft.

EA22 Paragraphs EA10–EA17 describe the benefits that would result from those decisions: improved financial statements for assessing the timing, amount and uncertainty of cash flows, improved comparability of financial statements and better information for economic decision-making. The IASB believes that these benefits would outweigh the costs of providing this information. Furthermore, this Exposure Draft specifically seeks input on the balance of costs and benefits in each of those areas. The IASB intends to supplement the input from the comment letters on this Exposure Draft with a further understanding of the logistics of applying of those proposals through fieldwork.

The likely effect on the costs of analysis for users of financial statements

EA23 Because the proposed requirements may differ from existing practices for the accounting for insurance contracts, there may be a need for education among users of financial statements to help them interpret the results of applying this Exposure Draft. The extent of differences between existing practice and this Exposure Draft is likely to affect the costs of analysis for users of financial statements as follows:

(a) in general, the proposed requirements would provide improved information about changes in circumstances and about the different sources of earnings from insurance contracts. Such information could reduce the cost of analysis by providing that information directly to users of financial statements.

(b) when users of financial statements analyse companies from different countries, the problems of diversity in accounting models creates costs that would be alleviated by standardised practice. The IASB believes that this is an important and much-needed improvement.

(c) when national requirements have been in place for many years, the benefits of the improved information arising from this Exposure Draft need to be balanced against the loss of trend data and the need for education, which result from a change in established practice. The IASB observes that most of the information necessary for determining key performance indicators (KPIs), which are used to assess insurance contracts, will continue to be available from the notes or the face of the financial statements. Consequently, users of financial statements will be able to continue to assess trend data using these KPIs.

EA24 The IASB acknowledges that some users of financial statements would have lower costs if IFRS and US GAAP could achieve alignment of requirements for insurance contracts. Nonetheless, although there are differences between the model in this Exposure Draft and the proposed model that is being developed by the FASB, both models have the same fundamental principle: that an entity should measure an insurance contract on the basis of updated estimates that reflect the perspectives of the entity but, for market variables, are consistent with prices in financial markets. This means that the proposals would increase the convergence between accounting for insurance contracts applying IFRS and US GAAP compared to today. In addition, some of the disclosures required will allow users of financial statements to reconcile the amounts reported under both models.

Conclusions

EA25 Many entities will be required to change their existing practices for the accounting for insurance contracts. Consequently, both preparers and users of financial statements would be subject to increased costs as a result of the proposed requirements.

EA26 However, many users of financial statements find the existing financial reporting for insurance contracts opaque, particularly with respect to the risks facing the entity. In addition, the differences in reporting for insurance contracts among entities in the IFRS jurisdictions and the differences between financial reporting for insurance contracts and for other similar transactions has made it difficult for investors and other users to understand the rights and obligations of entities that issue insurance contracts and the financial performance of those entities. As a result, some believe that some entities with insurance contracts have an excessively high cost of capital.

EA27 In the IASB's view, the benefits of the improved financial information as set out in paragraphs EA10–EA17 would outweigh the costs of implementing the proposals. The IASB's expects that its proposals will increase the understanding of the financial statements of entities with insurance contracts through greater transparency about insurance contracts and better comparability between different types of transaction.

Appendix C
Summary of changes since the 2010 Exposure Draft

The following table summarises the main differences between the 2010 Exposure Draft and this Exposure Draft.

Area of change	Description of change in proposals
Definition and scope	
Definition and scope	• Revised scope to include investment contracts with a discretionary participation feature but only if they are issued by an entity that also issues insurance contracts;[(a)] • Clarified scope exceptions by including more guidance about which fixed-fee services contracts are within the scope of the proposed Standard; and • Carried forward the current requirements of IFRS 4 *Insurance Contracts* and of IFRS 9 *Financial Instruments* for financial guarantee contracts. The entity applies the proposed Standard to financial guarantees that it issues if it previously treated those contracts as insurance contracts. The entity applies IFRS 9 if the entity has previously accounted for those contracts as financial instruments.
Separating components from insurance contracts	• Clarified the principles for separating components from the insurance contract. • Added guidance on the allocation of the cash inflows and cash outflows between the insurance and non-insurance components.
Recognition point	
Recognition	• Changed the recognition point in typical cases to the point at which the coverage period begins (or when the payment from the policyholder is due, if earlier). • Requires an entity to recognise the contract before the start of the coverage period when the insurance contract is onerous.

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Area of change	Description of change in proposals
Measurement	
Acquisition costs included in estimates of cash flows	• Revised requirement so that all directly attributable costs that arise when originating the portfolio of insurance contracts are included in estimates of cash flows. • Requires insurance contract revenue related to the recovery of those costs to be reported as the entity satisfies its contractual obligations by providing services.
Contract boundary	• Amended the contract boundary so that cash flows are outside the boundaries of the existing contract if an entity is able to reprice the portfolio that includes the contract, so that the price charged for the portfolio as a whole fully reflects the risk of the portfolio.
Time value of money	• Clarified guidance to indicate that both 'top-down' and 'bottom-up' approaches are acceptable for developing a discount rate that is consistent with the characteristics of the liability. • Included more application guidance on calculating the 'top-down' rate.
Risk adjustment	• Revised the objective to reflect the compensation that the entity requires for bearing the risk of uncertainty that is inherent in the cash flows that arise as the entity fulfils the portfolio of insurance contracts. • Eliminated the restriction of techniques to determine the risk adjustment. • Revised the approach to diversification benefits so that, when determining the risk adjustment, the entity considers the effects of diversification benefits considered in the compensation required for bearing the uncertainty.

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Area of change	Description of change in proposals
Contractual service margin[(b)]	• Introduced a requirement that an entity must adjust the contractual service margin for changes in estimates of cash flows related to future coverage or future services. The contractual service margin shall not be negative. • Revised the pattern for recognising the contractual service margin over the coverage period to be on the systematic basis that reflects the remaining transfer of services that are provided under the contract.
Modifications to insurance contract	• Introduced requirements for the accounting of modifications to an insurance contract.
Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items	
Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items	• Introduced requirements for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. For such contracts, an entity is required to measure and present fulfilment cash flows that are expected to vary directly with returns on underlying items on the same basis as the underlying items.
Premium-allocation approach	
Eligibility	Revised to permit entities to apply the premium-allocation approach if: • doing so would produce a reasonable approximation to the general approach proposed in this Exposure Draft; or • the coverage period is within one year or less.

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Area of change	Description of change in proposals
Measurement	• Introduced additional simplifications, including an exception from discounting both the liability for the remaining coverage[(c)] and the liability for incurred claims if the entity meets the criteria. • Revised a requirement to assess whether a contract is onerous only when facts and circumstances indicate that the portfolio may be onerous.
Reinsurance contracts held	
Recognition point	Revised the recognition point to: • the beginning of the coverage period if the reinsurance coverage is based on aggregate losses of underlying direct insurance contracts; otherwise, when the underlying direct insurance contracts are recognised.
Contractual service margin	• Revised to require that an entity must recognise a contractual service margin (being expected net profit or net cost) over the coverage period. • Revised to require that the entity must recognise immediately in profit or loss the net cost related to past events. • Introduced a requirement that an entity should adjust the contractual service margin for changes in estimates of cash flows related to future coverage or future services. Changes in expected credit losses are recognised in profit or loss because they do not relate to future services.
Premium-allocation approach	• Clarified that the policyholder of a reinsurance contract could apply the premium-allocation approach provided it meets the eligibility criteria.

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Area of change	Description of change in proposals
Presentation and disclosure	

Interest expense in profit or loss and other comprehensive income	• For contracts that require the entity to hold underlying items and specify a link to returns on those underlying items, the entity shall:
	  • recognise and present changes in estimates of those fulfilment cash flows that are expected to vary directly with returns on underlying items consistently with changes in estimates of the underlying items;
	  • recognise changes in fulfilment cash flows that are expected to vary indirectly with returns on underlying items in profit or loss; and
	  • recognise and present changes in other fulfilment cash flows as it does for other contracts.
	• For other contracts, the entity shall recognise in profit or loss interest expense on the insurance contract liability using the discount rates that were applied when the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update the discount rates when it expects any changes in those returns to affect the amount of those cash flows.
	• An entity shall recognise in other comprehensive income, the income and expense that arise from changes in the insurance contract liability other than the amounts recognised in profit or loss.

Presentation of insurance contract revenue and expenses	• Added requirements for the entity to present insurance contract revenue in the statement of profit or loss and other comprehensive income over the coverage period, and claims and expenses when incurred. • The amount of revenue and claims recognised excludes investment components.

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Area of change	Description of change in proposals
Disclosures	Revised some disclosures in response to feedback received on the 2010 Exposure Draft and on the changes in presentation of insurance contracts: • added disclosure for new contracts written in the period; • added a reconciliation between premiums received and amount of insurance contract revenue presented; • added disclosure requirements for the insurance contracts and reinsurance contracts to reconcile the difference between the expected cash flows, risk adjustment and contractual service margin included in the opening and closing balance; • added disclosure requirements for reconciling the insurance contracts and reinsurance contracts; • eliminated the required disclosures for measurement uncertainty analysis; and • eliminated the prohibition against aggregating information about different reportable segments required by IFRS 8 *Operating Segments*.
Transition and effective date	
Modified retrospective application	• Introduced requirements to apply the proposals retrospectively in accordance with IAS 8 when practicable. • Provided simplifications if retrospective application is impracticable.
Designation of financial instruments using IFRS 9	• Revised to permit an entity, when first applying the proposals, to redesignate some financial assets provided specified criteria are met.

(a) Previously referred to as 'financial instruments with discretionary participation features'.
(b) Previously referred to as 'residual margin'.
(c) Previously referred to as 'pre-claims liability'.

Appendix D
Differences between the proposals in this Exposure Draft and the FASB's Exposure Draft

The FASB's involvement

D1 In August 2007 the US Financial Accounting Standards Board (FASB) issued an Invitation to Comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*, which included the IASB 2007 Discussion Paper. The FASB received 45 comment letters in response. In October 2008 the FASB, supported by the responses in the comment letters, decided to participate in the project with the IASB, with the objective of improving and simplifying US GAAP, and enhancing the convergence of the, financial reporting requirements for insurance contracts and to provide investors with useful information for making decisions. However, this project was not part of the Memorandum of Understanding that was agreed with the FASB in 2002 and updated in 2006 and 2008, which had the aim of achieving improvements in accounting standards and increasing the convergence of IFRS and US Generally Accepted Accounting Principles (US GAAP).

D2 From February 2009, when the FASB joined the project, many of the decisions on the features of the insurance contracts model were made jointly with the FASB. However, in mid–2010, the FASB decided to seek additional feedback before publishing an Exposure Draft. Consequently, in July 2010, the IASB published an Exposure Draft on insurance contracts separately from the FASB. The FASB published its Discussion Paper *Preliminary Views on Insurance Contracts* in September 2010. That Discussion Paper noted the following reasons for issuing a Discussion Paper instead of an Exposure Draft of a proposed Accounting Standards Update:

(a) the extent of the IASB's and the FASB's current accounting guidance for insurance contracts varies significantly. Existing US GAAP comprehensively addresses accounting for insurance contracts by insurance entities, whereas IFRS does not have comprehensive guidance. Whether or not the proposed approaches would improve current guidance must be judged by reference to the significantly different starting points in US GAAP and IFRS. In addition, the FASB was seeking additional input on whether the guidance proposed in the FASB's Discussion Paper and the model proposed in the IASB's 2010 Exposure Draft, would represent an improvement to US GAAP.

(b) the FASB had not determined whether one or two models would result in more useful information about insurance contracts. Current US GAAP has separate models for long- and short-duration contracts, with derivations within the long-duration model based on policy type. The FASB wanted to obtain additional input from stakeholders on whether different types of insurance contracts warranted different recognition,

measurement and presentation and, if so, what the criteria should be for determining which, if any, types of insurance contracts would use each model.[8]

D3 After jointly deliberating on the issues arising from the IASB's 2010 Exposure Draft and the FASB's Discussion Paper, the IASB and the FASB are publishing separate Exposure Drafts on their proposals on insurance contracts. This reflects the fact that the IASB is seeking input only on areas that it had not previously considered, whereas the FASB is publishing its first Exposure Draft for this project and is therefore seeking input on the complete package of proposed improvements to US GAAP.

D4 The FASB intend to publish an Exposure Draft on their proposals on insurance contracts shortly after the date of the publication of this Exposure Draft. The FASB decisions discussed in this document refer to decisions made up to the date of the publication of this Exposure Draft.

Differences between the proposals in the IASB's and the FASB's Exposure Drafts

D5 Many aspects of the model proposed in this Exposure Draft were decided jointly with the FASB. Joint decisions of the IASB and the FASB include:

(a) the proposals should apply to insurance contracts within the scope of the proposed Standard, regardless of the business of the entity issuing the contract.

(b) entities should measure insurance contracts using:

(i) an explicit, unbiased and probability-weighted estimate of the future cash flows that are expected to arise as the entity fulfils the contract, adjusted to reflect any link between the contract and any underlying items;

(ii) updated estimates and assumptions that are, to the best extent possible, consistent with prices in financial markets; and

(iii) a discount rate that reflects only the characteristics of the liability, including the extent of the dependency (if any) of the insurance liability cash flows on asset returns.

(c) entities should not recognise gains at contract inception.

(d) entities should present insurance contract revenue as they provide the coverage and other services needed to fulfil the contract. Entities should present claims and expenses when they are incurred.

(e) entities should recognise in profit or loss interest expense measured using the discount rate at contract inception, updated to reflect any changes in returns on underlying items if the cash flows of the contract are expected to vary with returns on those underlying items (see also paragraph D7). The difference between that interest expense and the

8 The FASB has since confirmed that there should be separate models for contracts with different characteristics.

interest expense that is measured using a current discount rate would be recognised in other comprehensive income.

(f) the premium-allocation approach would, in general, be applied to the measurement of the liability for the remaining coverage of contracts with a coverage period of less than a year or contracts that meet specified criteria.

D6 However, there are some differences between the IASB's proposals and the FASB's proposals, particularly in the representation of the profit that the entity recognises over the life of an insurance contract. Both the IASB's and FASB's proposals generally produce the same measurement at initial recognition of the insurance contract. Both the IASB's and the FASB's models calibrate the measurement of the insurance contracts as a whole to the expected consideration from the policyholder.[9] However, differences arise after initial recognition because:

(a) the IASB's model includes an explicit risk adjustment that would be remeasured each period with changes recognised in profit or loss, and allocates the contractual service margin on the systematic basis in line with the pattern of services provided under the contract. In contrast, in the FASB's building block approach the margin is rateably recognised in profit or loss when the associated cash flows become more certain.

(b) the inclusion of a risk adjustment in the IASB's model means that a contract is more likely to be considered onerous at contract inception.

(c) in the IASB's model a net increase in expected future cash outflows relating to future coverage or future services is offset against the contractual service margin unless the contract is onerous, and a net decrease in expected future cash outflows is added to the margin. In contrast, in the FASB's building block approach, all changes in cash flow estimates are recognised immediately in profit or loss and as an adjustment to the insurance liability, except for contracts with discretionary participation features. For such contracts, any changes in the ultimate expected cash flows related to a change in the estimated interest crediting rate are recognised immediately in other comprehensive income. Thereafter, such changes are recognised in profit or loss on a level-yield basis over the remaining life of the contracts. If the expected cash flows (including specified acquisition costs) of a portfolio exceeds the expected cash inflows, the remaining margin is recognised immediately in profit or loss.

D7 The following table sets out additional differences between the IASB's decisions and the FASB's decisions. Those differences reflect the IASB's and the FASB's differing views on the appropriate accounting for insurance contracts. It lists only the more significant differences and is not intended to be complete.

9 At contract inception, the margin in the FASB's model is the sum of the risk adjustment and the contractual service margin.

Issue	IASB's decisions	FASB's decisions
Unconditional rights to premiums	Rights to premiums, including the effect of the credit risk of the policyholder, is treated in the same way as other expected cash flows.	Any unconditional right to premiums or other consideration is separately recognised as a financial instrument. Consequently, the credit risk of the policyholder is accounted for on an expected value basis in accordance with US GAAP guidance on credit losses.
Premium-allocation approach	The premium-allocation approach is a simplification of the requirements of this Exposure Draft. Permits the premium-allocation approach for insurance contracts and reinsurance contracts when it produces similar measurements to the building block approach.	The premium-allocation approach is a separate model required for contracts that meet specified criteria. Requires premium-allocation approach for all direct insurance contracts that meet specified criteria. A cedant should account for a reinsurance contract using the same approach that the cedant used to account for the underlying insurance contracts.
Allocation period for margin	For all contracts: • contractual service margin is allocated over the coverage period. • the risk adjustment is released over the coverage and settlement periods.	The margin is allocated over the coverage and settlement periods for contracts that apply core proposals. The implicit margin in the premium-allocation approach is allocated over coverage period.

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Issue	IASB's decisions	FASB's decisions
Acquisition costs	Initially, the margin reflects the expected profit after considering all directly attributable costs of acquiring the portfolio of insurance contracts.	Initially, the margin reflects the expected profit after considering specified costs of acquiring issued insurance contracts. Those costs exclude the portion of acquisition costs that are deemed not to result in the issue of contracts.
Fulfilment cash outflows	The measurement of the insurance contract includes all cash outflows that will arise as the entity fulfils the portfolio of contracts, including commissions, transaction-based taxes (eg value added taxes), and levies (eg regulatory assessments) that arise directly from existing insurance contracts, or can be attributed to them on a reasonable and consistent basis. Consequently, in a mutual entity, if the contract provides policyholders with the right to participate in the whole of any surplus of the issuing entity, there would be no equity remaining and no profit reported in any accounting period.	The measurement of the insurance contract includes cash outflows that an entity will incur to directly fulfil its obligations to the portfolio of policyholders, or can be attributed to them on a reasonable and consistent basis. Therefore, it does not include other expenses unrelated to or only indirectly related to satisfying these specific obligations, such as, commissions, transaction-based taxes (eg value added taxes), or levies (eg regulatory assessments). Consequently, a mutual entity treats as equity an appropriate amount of surplus that the entity does not have the obligation or intention to pay out in fulfilling insurance contract obligations.

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Issue	IASB's decisions	FASB's decisions
Exception to eliminate accounting mismatch when no economic mismatch can arise for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items	Applies to all expected cash flows relating to the policyholder's participation.	Does not apply to: • situations in which the policyholder's participation is determined on a basis other than that used to measure the underlying items in the financial statements and that difference does not reflect a timing difference that will reverse and enter into future calculations of participating benefits; or • any cash flows for which the entity has discretion on the amounts relating to the policyholder's participation.

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Issue	IASB's decisions	FASB's decisions
Discount rate used to measure interest expense in profit or loss for cash flows that are expected to vary directly with returns on underlying items	Updated when the entity expects changes in returns on underlying items to affect the amount of the cash flows to the policyholder. That discount rate is the rate that reflects the characteristics of the insurance liability either at contract inception or when the rate is updated.	When the entity expects changes in the crediting rates, reset in a manner that recognises any changes in estimated interest crediting and related ultimate expected cash flows on a level-yield basis over the remaining life of the contracts. The degree to which the rates are adjusted reflects the relative value of the account balances to be credited and the extent to which the change in the expected crediting rates related to the changes in the asset returns impacts the present value of expected cash flows.
Credit risk of the counterparty in a reinsurance contract	The credit risk of the issuer of a reinsurance contract held is accounted for consistently with other estimates.	The credit risk of the issuer of a reinsurance contracts held is accounted for on an expected value basis in accordance with US GAAP guidance on credit losses.

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Issue	IASB's decisions	FASB's decisions
Transition	When determining the margin at transition, an entity shall determine the portfolio in accordance with the proposed definition of 'portfolio'. If it is impracticable to apply the proposed Standard retrospectively, an entity shall estimate the contractual service margin, taking into account all objective information that is reasonably available and by applying specified simplified requirements. An entity may designate financial assets using the fair value option and equity instruments at FVOCI when first applying the proposed Standard to the same extent that entities would have been able to designate financial assets when first applying IFRS 9.	When determining the margin, an entity may measure the insurance contract liability and its margin by aggregating contracts at the level of the portfolio used immediately prior to transition. If it is impracticable to apply the proposed Standard retrospectively, an entity shall estimate the margin taking into account all objective information that is reasonably available. If there is no objective information that is reasonably available to retrospectively adopt the proposed Standard or to estimate what the margin would have been, the margin recorded should be zero. An entity shall classify its financial assets that are identified as relating to its insurance business either by legal entity or internal determined or relating to funding of insurance contracts that are newly designated to be insurance, as if it had adopted on the transition date the relevant classification and measurement guidance for financial instruments in effect.

D8 The FASB model has also introduced additional requirements and exemptions for segregated fund arrangements and the related segregated portfolios of assets, a notion similar to that of unit-linked contracts. The FASB tentatively decided:

(a) to provide criteria that a segregated fund arrangement needs to meet in order to apply those additional requirements;

(b) to require that the guidance, in Subtopic 944–80, *Financial Services—Insurance—Separate Accounts* in the *FASB Accounting Standards Codification*®, on the entity's consideration of qualifying segregated fund arrangement when performing analysis for consolidation must be retained;

(c) to require that the entity records the contract policyholder funds and its proportionate interest in the qualifying segregated fund arrangements at fair value through net income; and

(d) to introduce additional presentation and disclosures for these segregated fund arrangements.

Alternative view of Stephen Cooper

AV1 Mr Cooper voted against the publication of this Exposure Draft because he disagrees with the proposals for recognising gains and losses on insurance contracts in other comprehensive income and recognising in profit or loss interest expense to reflect the time value of money using an approach that is similar to that applied to financial instruments at amortised cost. In his view, these proposals would result in measures of profit or loss that fail to faithfully represent the performance of an entity issuing insurance contracts, which could mislead users of financial statements.

Use of other comprehensive income is inconsistent with current measurement and adds complexity

AV2 The IASB has spent many years developing a current-value based measurement approach for insurance contract liabilities using current estimates of cash flows and a current discount rate. The IASB has done so on the basis that only an approach that uses updated estimates can provide relevant information. The proposal in this Exposure Draft to base profit or loss on an alternative 'cost'-based method, using a locked-in discount rate, is inconsistent with this approach. Interest measured at historical locked-in rates has no relevance to the business at the current reporting date and is inconsistent with the whole rationale of the model that the IASB has developed. If 'locked-in' assumptions are not good enough for the statement of financial position, Mr Cooper does not see why they would be used for the main measure of performance: profit or loss.

AV3 Furthermore, Mr Cooper believes that the proposal to use other comprehensive income significantly increases complexity compared with the proposals in the 2010 Exposure Draft, because it requires entities, in effect, to keep two measurement bases for each insurance contract. This would create significant tracking requirements for preparers and would make it much more complex for users of financial statements to understand performance measures. As a result, it perpetuates the lack of transparency that is such a frequent complaint about existing accounting for insurance contracts.

Proposed disaggregation may mislead users of financial statements

AV4 Mr Cooper supports the disaggregation of gains and losses for items measured at a current value. He believes that appropriate disaggregation enables users of financial statements to isolate market-related value changes, to differentiate components of gains and losses that have differing degrees of persistence and, in the case of insurance contracts, to separate underwriting results from interest flows and other value changes. However, he believes that the proposals in the Exposure Draft:

(a) do not disaggregate profit or loss in an informative way, thereby concealing relevant information;

(b) create extensive accounting mismatches; and

(c) result in measures of profit or loss that are arbitrary.

Inappropriate disaggregation conceals relevant information

AV5 The amount reported in other comprehensive income under the proposals includes two components. The first component is the effect on the insurance contract liability of changes in discount rates in the period. The second component is the difference between interest accretion in the period measured by using a locked-in rate and interest accretion in the period that is measured using a current rate. Mr Cooper believes that the first component provides relevant information, but that the second component is merely a mechanical effect that does not depict any economic phenomenon and hence is of no relevance to users of financial statements.

AV6 Consider, for example, a situation in which the discount rate applied in the measurement of an insurance contract changes in a particular period. Mr Cooper agrees that the gain or loss arising from this change in discount rate (whether reported in other comprehensive income or not) is meaningful and should be clearly identified, particularly when viewed in conjunction with the fair value changes for assets held. Any net gain or loss indicates the extent and implications of any duration mismatches or any other economic mismatches. However, if in the following period the insurance liability discount rate remains the same, the proposals in the Exposure Draft would still report a gain or loss in other comprehensive income because of the continued use of a locked-in rate for interest accretion, even though no economic gain or loss arose. While in the first period other comprehensive income gave meaningful information, this is not true in the following period. In practice, because of the volume of insurance contracts written by an entity, other comprehensive income would be a confusing mixture of the economic impact of the changes in discount rates and the meaningless reversal of the past effects as they unwind. Mr Cooper believes that a better way to separate the effect of changes in discount rates is to limit the disaggregated amount to only the effect of changes in discount rates in the period of change.

AV7 Paragraph BC119 states that the amounts recognised in other comprehensive income due to changes in discount rates automatically unwind over time to zero when the cash flow occurs. This implies that such items are somehow temporary, that they will not affect cash flow and are consequently less important than other gains and losses. However, an automatic unwinding only occurs when the liability is considered in isolation and Mr Cooper does not believe that it justifies this approach.

AV8 In practice, the proposals would result in an entity reporting in other comprehensive income gains and losses that can represent very real effects when considered holistically in an asset-liability management context. For example, consider an insurance liability that is backed by assets with a shorter duration. A significant reduction in discount rate would not only cause an increase in the liability but, at the same time, there is likely to be a consequential cash shortfall in the future caused by the probable lower reinvestment rate on the related asset when that asset matures. The overall effect of the reduction in discount rate is therefore a real economic loss that would only reverse if economic conditions were to change. Mr Cooper believes that the economic effect of the duration mismatch in this situation should be made transparent in the period in which it

arises; however, he does not believe that the proposals in this Exposure Draft achieve this. He also does not believe that a loss recognition test, as advocated by some interested parties and discussed in paragraphs BC154–BC157, would address this issue, because it would result in an incomplete picture of the effects of investment mismatches, as described in paragraph BC156(c).

Proposed disaggregation creates extensive accounting mismatches

AV9 Mr Cooper believes that there is even less justification for the proposed use of other comprehensive income for insurance contract liabilities when this approach is considered together with the accounting for the assets held by an insurer applying the proposed changes to IFRS 9 *Financial Instruments*. The combined effect of the proposals for financial assets and for insurance contracts may create significant accounting mismatches. Such accounting mismatches will only be avoided in the unlikely situation that all of the following conditions apply: all financial assets held by an insurer are measured as at fair value through other comprehensive income, the duration of those financial assets matches that of the liabilities, no derivative positions are established as part of asset-liability management, the insurance premium is a single payment at contract inception and none of the assets are sold prior to maturity. If any of these conditions are violated, which Mr Cooper believes will be the case for almost every entity, accounting mismatches will inevitably result.

AV10 Assume, for example, that an insurance liability is perfectly matched by related assets, but that an asset is then sold and the proceeds from that sale are immediately reinvested in an equivalent asset in such a way that the investment and duration match is maintained. There is clearly no resulting change in the entity's economic position, so it would seem odd if any (net) gain or loss were to be recognised. However, the proposals would reclassify from other comprehensive income to profit or loss the gain or loss in respect of the asset—but with no equivalent reclassification in respect of the insurance liability.

AV11 Mismatches would also arise where cash outflows under an insurance contract are affected by inflation because changes in inflation expectations are generally correlated with changes in nominal discount rates. Mr Cooper believes that it would be misleading to report changes in cash flows that are induced by changes in inflation expectations as an adjustment to the margin (if applicable) or in profit or loss and to recognise the effect of the related change in discount rates in other comprehensive income. Such an approach would produce profit or loss volatility where no economic volatility may exist.

AV12 Mr Cooper believes that the accounting mismatches described in paragraphs AV9–AV11 would make it impossible for any user of financial statements to understand what the overall amounts recognised in profit or loss and other comprehensive income really indicate about the entity's performance. The IASB's proposals would force this result on almost every entity that issues insurance contracts.

Arbitrary measures of profit or loss

AV13 Mr Cooper believes that the IASB's proposals result in arbitrary measures of profit or loss when considered in conjunction with the proposals for a contract that require the entity to hold underlying items and specifies a link to returns on those underlying items. For such contracts, paragraphs 66 and B85–B87 would require entities to divide the cash flows that do not vary with returns on underlying items (to which the other comprehensive income proposals would be applied) from the cash flows that vary directly or indirectly with underlying items. However, there are multiple ways in which such decomposition could be done, as illustrated by the three very different versions shown in the example in paragraph B86. As discussed in paragraph BC130, each method of analysis would result in different amounts being reported in other comprehensive income and profit or loss. In Mr Cooper's view there is no conceptual or practical reason to prefer one method of cash flow analysis to another and that, consequently, any amounts reported in other comprehensive income and profit or loss are arbitrary and potentially misleading. He believes that the approach to choosing the decomposition method specified in paragraph B86 is merely an arbitrary rule, which is not based on any clear objective regarding performance measurement. Furthermore, in practice that arbitrary rule may not even provide a clear answer to the practical question of how to analyse cash flows in all cases.

Disaggregation using other comprehensive income is unnecessary

AV14 Finally, Mr Cooper believes that disaggregation using other comprehensive income is unnecessary for the reasons that follow.

Volatility mitigated through other means

AV15 Mr Cooper believes that a key motivation for the IASB when developing the other comprehensive income proposals in paragraphs 60(h) and 64 is to respond to the concerns raised by some respondents that the application of the proposals in the 2010 Exposure Draft would result in excessive volatility in profit or loss. While the proposed use of other comprehensive income may well reduce such volatility in practice (although this would not always be the case), it is done at the expense of any clear economic meaning for profit or loss. In any case, Mr Cooper believes that the changes proposed in this Exposure Draft, ie those related to calculating the discount rate, reflecting the link to returns on underlying items in measuring insurance contracts and adjusting the contractual service margin to reflect changes in future services, act together to effectively mitigate such volatility, making the use of other comprehensive income unnecessary. In particular Mr Cooper believes that permitting a top-down approach to calculating the discount rate for insurance liabilities means that changes in asset values due to market movements that are unrelated to expected credit losses and investment risk (such as changes in asset prices due to market sentiment and liquidity changes) would now largely be matched by equivalent changes in insurance liabilities. As a result, volatility caused by the

effects of these market factors is eliminated, thereby ensuring that gains and losses related to insurance liabilities would reflect only actual changes in an entity's economic position.

Disaggregation need not use other comprehensive income

AV16 Mr Cooper does not object to showing some appropriately disaggregated items in other comprehensive income instead of profit or loss. However, he observes that IAS 1 gives considerable flexibility in the presentation of performance in the statement of profit or loss and other comprehensive income. That flexibility means that if the full change in the current value of insurance liabilities were recognised in profit or loss, as consistently proposed by the IASB prior to this Exposure Draft, then entities would easily be able to separate the more persistent net underwriting result and net interest margin from the less persistent net investment result, which comprises the market driven investment gains and losses and liability changes due to interest-rate movements. He believes that each of these three elements of performance is core to an insurance entity, albeit contributing to performance in different ways and hence requiring different analyses by users of financial statements. Recognising the full change in the current value of insurance liabilities in profit or loss would thus enable entities to disaggregate information in a meaningful way, while (as described in paragraph BC136) enabling them to avoid accounting mismatches by electing to use the fair value options available for the assets.