

March 2015

Project Update

Insurance Contracts without Participation Features

Insurance contracts without participation features

What is the purpose of this document?

This document provides an update on the tentative decisions reached on the IASB's general model for insurance contracts and explains the IASB's reasons for reaching those decisions. The general model would be applied to all insurance contracts without participation features.

Project status

The IASB published a revised Exposure Draft *Insurance Contracts* (the '2013 ED') in June 2013. The IASB received extensive feedback on its proposals and has heard a broad range of views.

The IASB has redeliberated and reached tentative decisions on substantially all of the issues relating to its general model for insurance contracts. It will continue to deliberate the modifications to the general model that may be needed for contracts with participation features. It plans to review the implications of any such modifications for the general model before finalising the project.

The IASB expects to issue the new *Insurance Contracts* Standard after 2015.

Why change the requirements for insurance contracts accounting?

Insurance contracts often expose entities to long-term and uncertain obligations. However, existing insurance contracts accounting does not provide existing and potential investors, lenders and other creditors with the information they need to:

- (a) understand the financial statements of entities that issue insurance contracts; or
- (b) make meaningful comparisons between such entities.

Little or no comparability between entities that write insurance contracts

When the IASB began its work in 2001, International Accounting Standards had no Standard on insurance contracts. In anticipation of adoption of IFRS by a number of jurisdictions, including the European Union, the IASB issued IFRS 4 *Insurance Contracts* in 2004. This Standard has allowed entities to maintain their existing accounting practices, subject to improved disclosures about those practices and risks related to insurance contracts. IFRS 4 was intended as an interim measure pending a more fundamental reassessment of the accounting for insurance contracts.

Existing insurance contracts accounting does not often reflect economics and risks in a timely manner

Different issues in the existing accounting for insurance contracts arise in different jurisdictions. The most common issues are:

- (a) long-duration contracts are measured using outdated information.
- (b) entities use expected investment returns on assets for discounting the liabilities, even if the obligation to the policyholder is not dependent on the performance of the investments. This means that economic risks (for example, from options and guarantees embedded in the insurance contract) are not reflected.
- (c) the time value of money is not reflected, even when cash flows are due in the future.
- (d) little information is given about the sources of profit reported in the current period, or that is expected to be reported in future periods.
- (e) information about underwriting activity (for example, revenue or expenses) is often reported on a cash or cash-like basis even when service is delivered in a different period and such cash receipts often include deposits. In addition, current accounting often results in an opaque ‘change in the liability’ line item which is needed to reconcile cash-based amounts to the accruals-based result of the period. This is not comparable to how other industries report performance.

The IASB proposes to replace the existing IFRS 4 with a Standard that better meets the needs of users of financial statements

The proposals would improve financial reporting by providing more transparent, comparable information about:

- (a) the effect of the insurance contracts that an entity issues on the entity's financial performance;
- (b) the way by which entities earn profits, or incur losses, through underwriting services and investing premiums from customers; and
- (c) the nature and extent of risks that companies are exposed to as a result of issuing insurance contracts.

The IASB proposes a single accounting approach for insurance contracts that:

- (a) provides up-to-date market-consistent information about the entity's obligation, including the value of options and guarantees;
- (b) requires entities to reflect the time value of money on payments expected in the future;
- (c) reflects the characteristics of the insurance contract, rather than the assets that an entity holds, and therefore reflects the risks related to the investment activity;
- (d) provides separate information about the investment and the underwriting performance; and
- (e) treats the service provided by the underwriting activity as revenue and expenses in a comparable way to other, non-insurance businesses.

The IASB has consulted extensively in developing its proposals

The IASB has followed a comprehensive due process and undertaken extensive consultation with interested parties. That process included:

- (a) publishing three consultative documents (a Discussion Paper and two Exposure Drafts) on which it received comment letters from constituents including preparers, regulators, auditors and standard-setters;
- (b) meeting a broad range of stakeholders from all jurisdictions (including users of financial statements) that have an interest in insurance operations; and
- (c) testing the proposals in three rounds of fieldwork with preparers of financial statements.

An overview of accounting model for insurance contracts

The proposed Standard describes a measurement and presentation model for insurance contracts.
To apply the Standard, an entity would apply the following steps:

Identify and recognise the contract

- An insurance contract is defined by the presence of significant insurance risk, consistent with existing IFRS 4.
- Some distinct non-insurance components should be separated from the contract and accounted for using other Standards.
- An entity recognises an insurance contract when the coverage periods begins, unless the contract is onerous, in which case an entity recognises the insurance contract when it discovers that the contract is onerous.

Measure the contract at initial recognition

- The measurement of an insurance contract incorporates all available information about the expected cash flows related to fulfilling the insurance contract.
- The measurement must be consistent with observable market information.
- An entity may apply a simplified approach to measure part of the insurance contract in some circumstances (see page 10).

Remeasure in subsequent periods

- In each reporting period, an entity re-measures insurance contracts using updated assumptions about cash flows, discount rate and risk.
- An entity recognises the effect of changes in estimates relating to future service in the periods in which the service is provided, rather than in the current period (see page 7).

Present results in financial statements

- Revenue and expense for insurance contracts is consistent with that for non-insurance contracts (see page 8).
- An entity may choose to split the interest expense and present cost-based interest expense in profit or loss and the effect of changes in discount rates on the insurance contract in other comprehensive income (see page 8).
- Disclosures provide information about the amounts recognised in the financial statements, the significant judgements used and the risks that arise from insurance contracts (see page 9).

Current market-consistent information on the statement of financial position

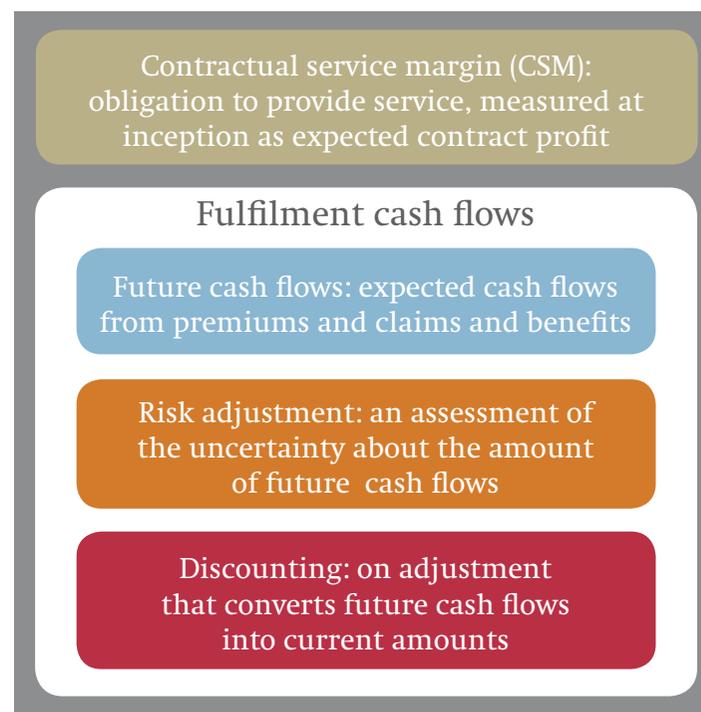
There is widespread support for the IASB's proposal that there should be a current market-consistent approach to measuring insurance contracts.

The proposed approach provides a current assessment of the net financial position at the end of each reporting period. The financial position reflects:

- (a) the net obligation to provide coverage (and other services) and to pay claims in future periods; or
- (b) the net right to the payment for the services provided in previous periods.

A current market-consistent approach ensures that the economic cost of the insurance contract, including embedded options and guarantees, will be transparent.

The insurance contract asset or liability is measured incorporating the following components:



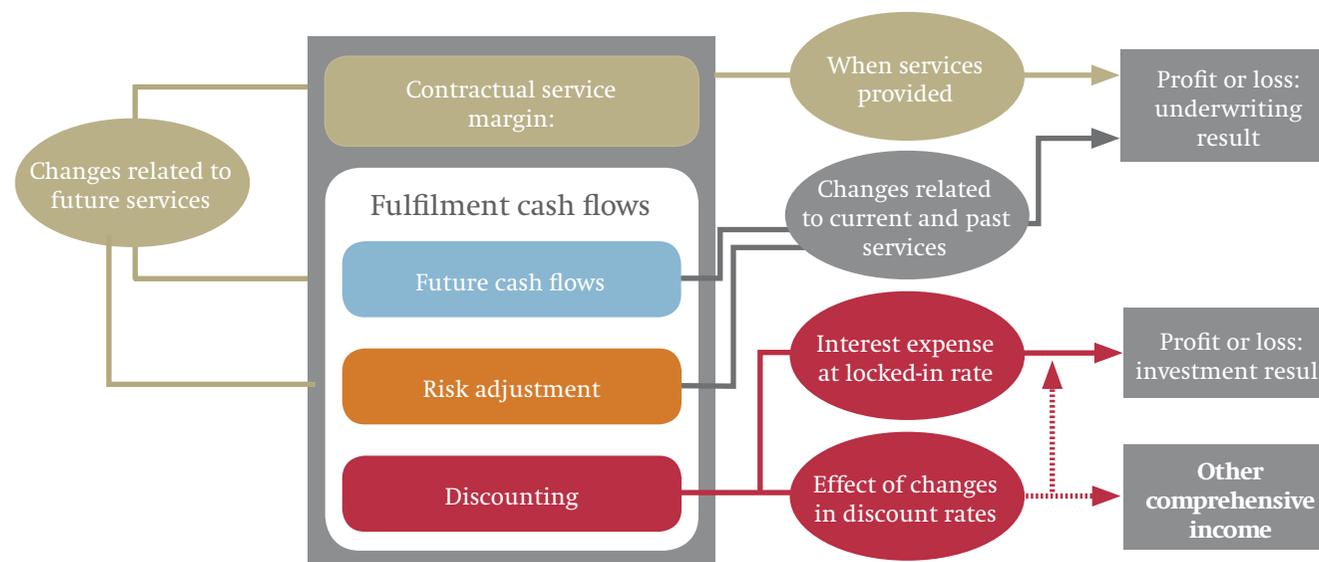
The Appendix includes a simplified numerical example that illustrates the measurement of the insurance contract at inception and over the coverage period.

Reflecting subsequent changes in the statement of financial position

Many constituents raised concerns about reporting all changes in the measurement of insurance contracts immediately in profit or loss. Many strongly believed that it would cause ‘unwarranted volatility’ and would not appropriately reflect the nature and timing of the services provided.

In response, the IASB proposed to disaggregate changes in the measurement of the insurance contracts in different line items of the financial statements, depending on the sources of the changes.

The changes in the measurement of the insurance contract are illustrated in the following diagram.



Thus, changes in the measurement of the liability relating to the underwriting services should:

- be recognised in profit or loss in the current period, if related to the service provided in the current and past periods; and
- adjust the contractual service margin so that they are recognised in profit or loss in future periods, if related to the service to be provided in future periods.

In addition, interest expense related to the financing activity may be disaggregated into a cost-based interest expense presented in profit or loss, and the effect of changes in the discount rate presented in other comprehensive income.

The statement of total comprehensive income explains sources of profit and improves comparability with other transactions

The existing accounting for insurance contracts often fails to explain clearly the sources of the entity's profit. In addition, it does not provide information that is comparable to other, non-insurance businesses.

The IASB's proposals make insurance contracts accounting less 'special'. Although some aspects of insurance contracts are sufficiently different and thus justify a different type of accounting, basic issues related to the measurement of insurance contracts and the presentation of its performance are similar to other industries.

The format of the statement of comprehensive income is illustrated in the following example.

Statement of comprehensive income

		20XX	
Insurance contracts revenue		X	Revenue and expense deposits are recognised as earned or incurred.
Incurred claims and expenses		(X)	
Underwriting result		X	
Investment income*		X	Interest expense is either current or locked-in, depending on accounting policy choice.
Interest on insurance liability		(X)	
Underwriting result		X	
Profit or loss		X	
Gains and losses on financial assets measured at fair value through OCI			If interest expense is locked-in, effect of difference between current and locked-in rates is presented in OCI.
Effect of discount rate changes on insurance liability (optional)		(X)	
Total comprehensive income		XX	

* Amounts recognised, measured and presented in accordance with IFRS 9 *Financial Instruments*

The statement of comprehensive income proposed by the IASB presents:

- (a) gains or losses on underwriting activity separately from gains or losses from investing premiums received from customers; and
- (b) revenue and expenses from insurance contracts consistently with the presentation of revenue and expenses in accordance with IFRS for other transactions.

The Appendix includes a simplified numerical example that illustrates the statement of total comprehensive income over the coverage period.

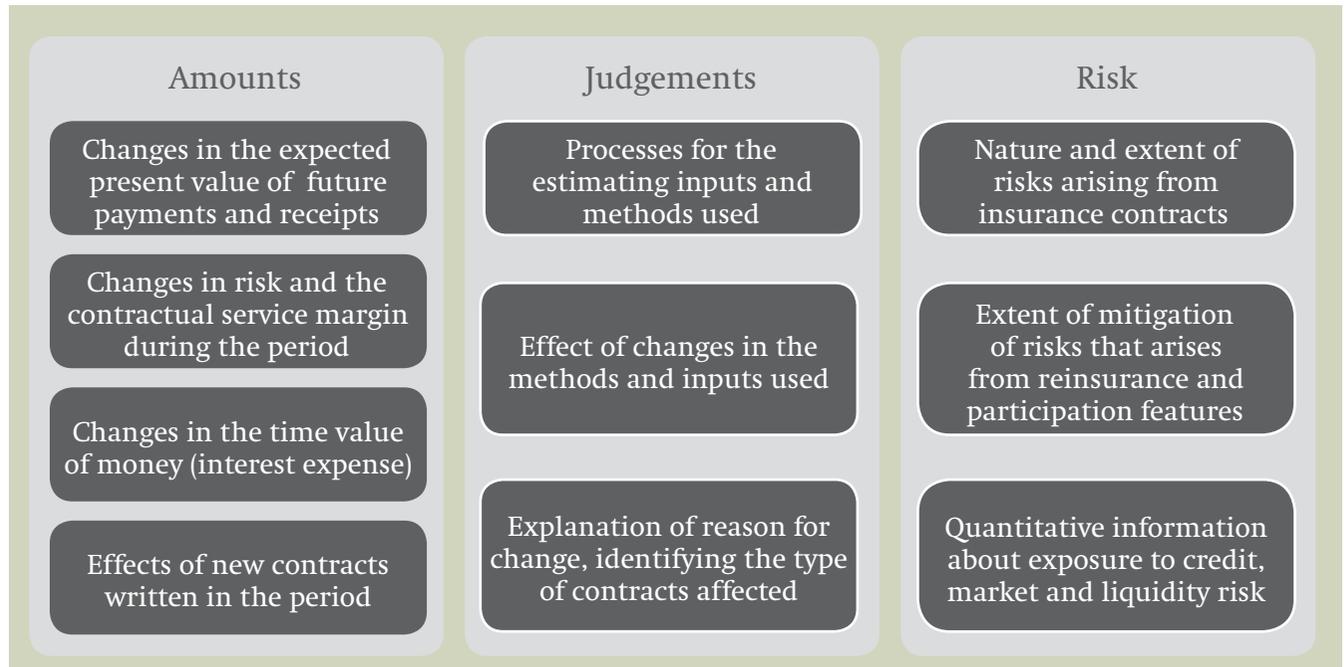
Disclosures explain the amounts recognised in the financial statements and the risks arising from the insurance contracts activity

The complexity of insurance contracts, their inherent risk and the need to base measurement on assumptions imposes a need for comprehensive disclosures to provide transparency.

The IASB proposes to extend the existing disclosures in IFRS 4 relating to the risks and amounts reported in the financial statements. In particular, there would be:

- (a) more detailed reconciliations between amounts recognised in the statement of financial position and performance for the period; and
- (b) more information about judgement used in measuring insurance contracts.

The disclosures will provide the following types of information:



A simplified measurement approach for simpler insurance contracts

The proposed Standard includes a simplified measurement approach that approximates the general proposals. The approach is expected to significantly reduce the costs of application of the new Standard for many entities.

The simplified approach is similar to the unearned premium reserve approach used in many jurisdictions today.

When could the simplified approach be used?

An entity could use the simplified approach when the outcome approximates that from applying the general measurement model, ie when significant changes in estimates are not expected before the claims are incurred, or when the coverage period of the contract is less than a year.

What is the simplified approach?

An insurance contract liability can be analysed as comprising:

- (a) the entity's obligations to pay for the insured events that are expected to occur in the future and that are covered by the existing contracts (ie the liability for the remaining coverage); and
- (b) the entity's obligation to pay claims for the insured events that have already occurred (ie the liability for the incurred claims).

The premium allocation approach provides a simplified way of measuring the liability for the remaining coverage. When applying that approach, an entity would:

- (a) on initial recognition, measure the liability for the remaining coverage at the premiums received under the contract, less any acquisition costs paid.

- (b) subsequently, accrete interest and reduce the liability for the remaining coverage over the coverage period on the basis of the passage of time (or the basis of the expected timing of incurred claims and benefits, if that pattern better reflects the release from risk).
- (c) recognise an additional liability if a contract is onerous. That liability calibrates the carrying amount of the liability for the remaining coverage to the amount of the fulfilment cash flows.

The liability for incurred claims is measured using the general model proposed by the IASB.

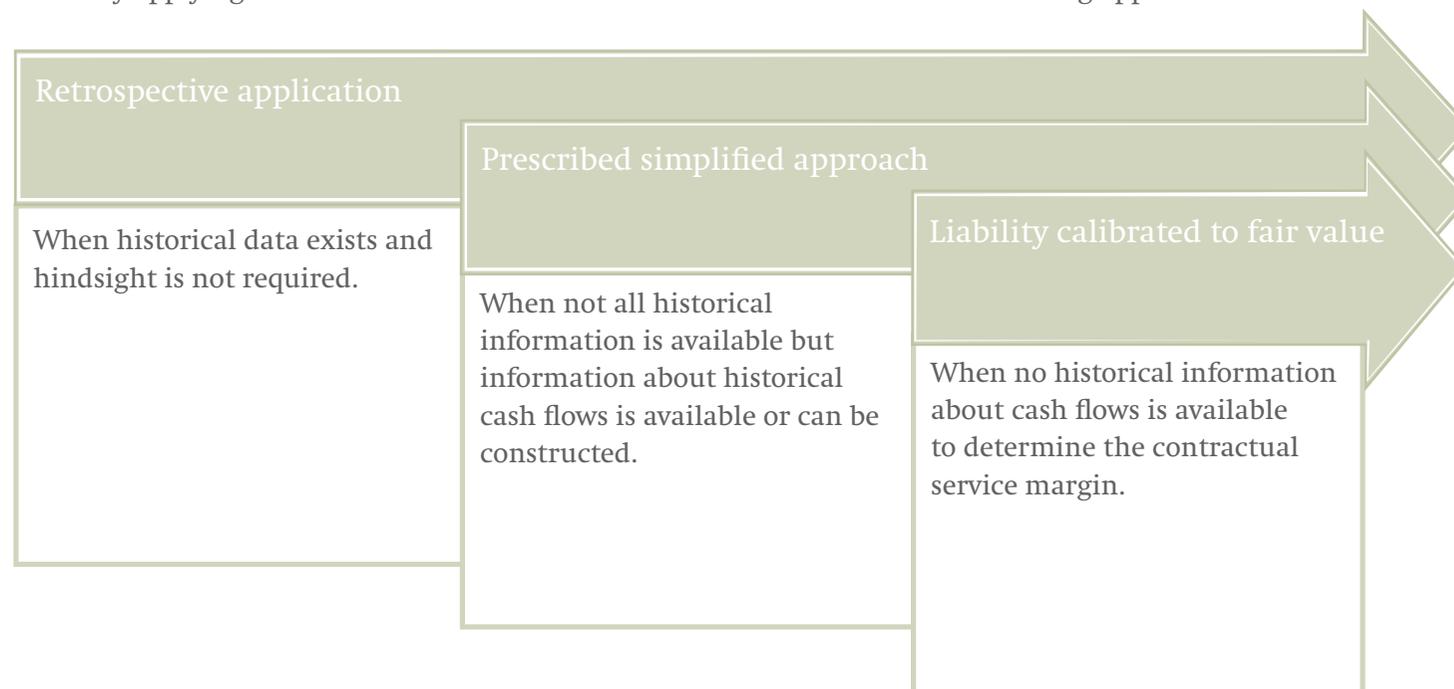
The Appendix includes a numerical example that illustrates how the simplified approach is applied at inception and subsequently, and how the simplified model approximates the general model.

Applying the new Standard for the first time

The proposals related to the application of the new Standard for the first time seek to balance:

- (a) the desire for comparability:
 - (i) between different entities applying the new Standard for the first time; and
 - (ii) between contracts written by an entity before and after the first application of the new Standard
- (b) the feedback from constituents suggested that any retrospective approach may be difficult to apply because it requires use of historical information.

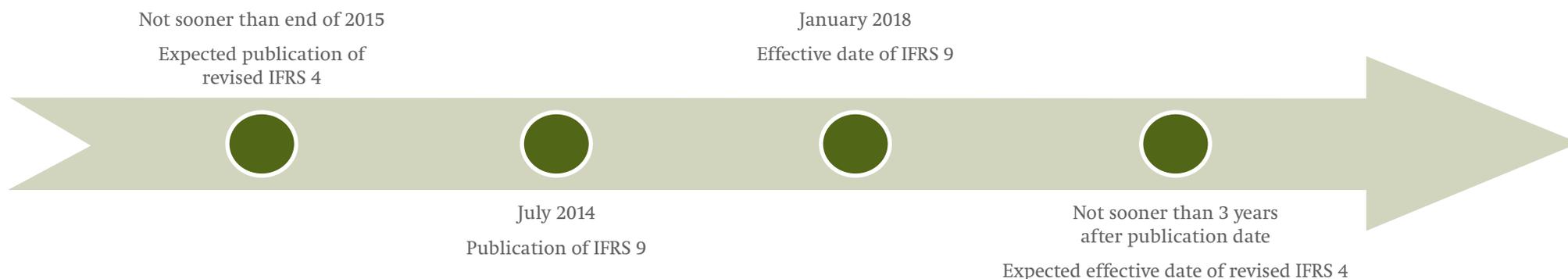
An entity applying the new Standard for the first time would use one of the following approaches:



The IASB proposes that an entity should apply new accounting policies that result from the new Standard as if those policies had always been applied, where practicable. This approach provides most comparability.

When this is not practicable, the IASB specifies two approaches to overcome difficulties in obtaining historical information for long-duration contracts.

Interaction with the first application of the revised IFRS 9 *Financial Instruments*



Many entities are concerned because they will be required to apply IFRS 9 before they are required to apply the insurance contracts Standard. They note that this may have unintended consequences on decisions they make when implementing IFRS 9.

The IASB will consider ways to ensure that entities that issue insurance contracts are not disadvantaged.

The 2013 ED proposed that on the first application of the insurance contracts Standard, an entity may:

- (a) use options for the classification and measurement of financial assets that, according to IFRS 9, are available only on initial recognition of those assets; and
- (b) early apply the insurance contracts Standard to avoid the costs of two significant changes in the consecutive periods.

In addition, at its January 2015 meeting the IASB tentatively decided to consider providing further transitional relief to permit or require an entity to reassess the business model used for the classification of its financial assets based on the facts and circumstances at the first application of the insurance contracts Standard.

Appendix

This Appendix includes two Examples:

- (a) Example 1 illustrates the measurement of the insurance contract in the statement of financial position at inception and subsequently. It includes two scenarios:
 - (i) Scenario A, which assumes that everything happened as expected during the coverage and settlement period; and
 - (ii) Scenario B, which assumes that there was a change in the expected cash flows during the coverage period.
- (b) Example 2 uses assumptions from Example 1, Scenario B and illustrates:
 - (i) how the simplified approach is applied to the measurement of the insurance contracts in the statement of financial position at inception and subsequently, and how the simplified measurement model approximates the measurement achieved by the general model proposed by the IASB; and
 - (ii) the total comprehensive income for both measurement models.

Example 1: Measuring an insurance contract using the general model

Scenario A: Assuming that everything happens as expected during the coverage and settlement period

A group of similar insurance contracts are issued to cover against the risk of theft for two years. The entity expects an inflow (premium) of CU500¹ paid immediately before the start of the coverage period (T_0).

A claim is expected to occur at the end of each year of coverage. The entity expects to settle the total claims of CU500 immediately after the end of year 5 (the time is used to assess the validity of claims). The risk adjustment related to the uncertainty of the expected cash flows is assumed to be zero.

The entity uses a discount rate of 3 per cent to calculate the current value of the obligation.

The entity would measure the fulfilment cash flows at inception (T_0) as follows:

Time	Components of the insurance contract liability	Nominal amount	Present value
T_0	Expected inflows	500	500
T_5	Expected outflows	(500)	(431)
	Net expected cash flows		69
	Risk adjustment		–
	Fulfilment cash flows at inception		69

¹ In this Example, currency amounts are denominated in ‘currency units’ (CU).

² If the entity enters into an onerous contract, no contractual service margin would be recognised. Instead, a loss would be recognised in profit or loss at inception.

Measurement at inception

The contractual service margin ensures that no profit arises at inception of the contract, but is instead recognised over the coverage period when the service is provided.² In essence, the profit represented by the contractual service margin is set at inception to be equal to the fulfilment cash flows. Consequently, when the insurance contract is issued before any cash is transferred or any service provided, the measurement of the contract is as follows:

Fulfilment cash flows	69
Contractual service margin	(69)
Insurance contract asset/liability	–

In other words, if the entity prepared financial statements when the contract had been written, but before the first premium had been received, the initial value of the insurance contract in this case would be zero. The present value of expected cash flows, the risk adjustment and the contractual service margin would all be shown separately in the notes to the financial statements.

Measurement when the first instalment of the premium is received

Immediately after the contract is issued, the first premium is received. As a result, the entity increases the assets for the cash received and increases the insurance contract liability for the amount of CU500. The components of the insurance contract liability change as follows:

Time	Components of the insurance contract liability	Nominal amount	Present value
T ₀	Expected premium	-	-
T ₅	Expected outflows	(500)	(431)
	Net expected cash flows		(431)
	Risk adjustment		-
	Fulfilment cash flows		(431)
	Contractual service margin		(69)
	Insurance contract liability after premium is received		(500)

The insurance contract liability at this point depicts the difference between what the entity has received and what it still needs to provide. In this example, the entity has received CU500 of cash, but has not yet provided any service or paid any claims.

³ A similar reconciliation is required in the notes to the financial statements.

Subsequent measurement over the coverage and settlement period

Assuming that everything progresses as expected, the amounts change as follows:³

Fulfilment cash flows*	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period	(431)	(444)	(457)	(471)	(485)
Interest accretion recognised in total comprehensive income	(13)	(13)	(14)	(14)	(15)
Balance at the end of the period	(444)	(457)	(471)	(485)	(500)**

Contractual service margin	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period	(69)	(35)	-	-	-
Interest accretion recognised in total comprehensive income	(2)	(1)	-	-	-
Amounts recognised in profit or loss	35	36	-	-	-
Balance at the end of the period	(35)	-	-	-	-

Insurance contract liability	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period	(500)	(479)	(457)	(471)	(485)
Balance at the end of the period	(479)	(457)	(471)	(485)	(500)

* The expected cash flows equal the fulfilment cash flows, because the risk adjustment equals zero.
 ** Claims are paid immediately after the end of year 5.

Scenario B: Assuming a change in the expected cash flows during the coverage period

Based on the recent amounts of claims, the entity reviews its estimates of the expected cash outflows paid after the end of Year 5:

- (a) The first change in the expectations occurs shortly after the contract is written. The entity expects the cash outflows to be CU530 rather than the initially expected CU500 (ie an increase of CU30, present value of CU26). As a result, the fulfilment cash flows increase by CU26. This change relates to the future coverage, so the contractual service margin will be decreased by CU26. Consequently, the entity will recognise a lower amount of the contractual service margin in the profit or loss than it initially expected. The change in the expected cash flows related to future coverage only affects the change between components of the insurance contract liability and, therefore, the total liability remains the same.
- (b) The second change in expectations occurs immediately before the end of Year 3 (after the coverage period has finished). The entity estimates an additional increase in the expected cash outflows of CU20 (present value at the time of change equal to CU18). The entity increases the fulfilment cash flows by CU18. This change in estimate relates to the coverage provided in the past, so there is no adjustment to the contractual service margin (the contractual service margin is zero after the coverage period). The change is instead recognised immediately in profit or loss.

Subsequent measurement over the coverage and settlement period

Fulfilment cash flows	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period	(431)	(471)	(485)	(518)	(534)
Change in estimates	(26)	-	(18)	-	-
Unwind of discount recognised in total comprehensive income	(14)	(14)	(15)	(16)	(16)
Balance at the end of the period	(471)	(485)	(518)	(534)	(550)

Contractual service margin	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period	(69)	(22)	-	-	-
Change in estimates	26	-	-	-	-
Interest accretion recognised as interest expense	(1)	(1)	-	-	-
Release recognised in profit or loss	22	23	-	-	-
Balance at the end of the period	(22)	-	-	-	-

Insurance contract liability	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period	(500)	(493)	(485)	(518)	(534)
Balance at the end of the period	(493)	(485)	(518)	(534)	(550)

* The expected cash flows equal the fulfilment cash flows because the risk adjustment equals zero.
 ** Claims are paid immediately after the fifth year.

Example 2: Measuring an insurance contract using the simplified approach and presenting the performance in total comprehensive income

Example 2 uses the same assumptions as Example 1, Scenario B. In addition, it assumes that an entity invests premiums received at inception of the contract in bonds with expected maturity at the end of Year 5. The interest rate for the bonds is 5 per cent per year.

	T ₀	T ₁	T ₂	T ₃	T ₄	T ₅
Insurance contract liability						
at the end of the period	(500)	(493)	(485)	(518)	(534)	(550)
Insurance contract liability measured using the general approach (please refer to Example 1, Scenario B for a detailed reconciliation)						
Fulfilment cash flows	(431)	(471)	(485)	(518)	(534)	(550)
Contractual service margin	(69)	(22)	-	-	-	-

Insurance contract liability **measured using the simplified approach** (please refer to page 10)

Liability for remaining coverage	T ₀	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period (A)	-	(500)	(258)	-	-	-
Interest accretion (B = A × 1.03)	-	(15)	(8)	-	-	-
Recognised in profit or loss (C = B ÷ 2)	-	258	265	-	-	-
Balance at the end of the period	(500)	(258)	-	-	-	-

Liability for incurred claims	T ₀	T ₁	T ₂	T ₃	T ₄	T ₅
Balance at the beginning of the period	-	-	(235)	(485)	(518)	(534)
Interest accretion	-	-	(7)	(15)	(16)	(16)
Claims incurred	-	(235)	(243)	(18)	-	-
Balance at the end of the period	-	(235)	(485)	(518)	(534)	(550)

Assets	T ₁	T ₂	T ₃	T ₄	T ₅	Total
Balance at the beginning of the period (E)	500	525	551	579	608	500
Interest accretion (F = E × 1.05)	25	26	28	29	30	138
Balance at the end of the period	525	551	579	608	638	638
Profit or loss⁴	T₁	T₂	T₃	T₄	T₅	Total
Insurance revenue	258	265	-	-	-	523
Claims incurred	(235)	(243)	(18)	-	-	(496)
Underwriting result	22	23	(18)	-	-	26
Interest income	25	26	28	29	30	138
Interest expense	(15)	(15)	(15)	(16)	(16)	(76)
Investment result	10	11	12	13	14	62
Profit or loss	32	34	(6)	13	14	88

⁴ The Example does not assume any changes in the discount rate. If there were changes in the discount rate, an entity could choose to present the changes in the investment activity that are related to the effect of the changes in the discount rate in other comprehensive income.

Further information

The IASB's redeliberations of the proposals in the 2013 ED have taken place in public meetings. Information about these meetings is available on the IASB's website.

Exposure documents and the comment letters are also available on the IASB's website.

To stay up to date with the latest developments of this project and to sign up for email alerts, please visit the project homepage on <http://go.ifrs.org/Insurance-Contracts>.

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