Project: **Insurance Contracts**

Topic: **Mitigating mismatches through presentation**

Objective

1. The exposure draft proposes that all changes in the insurance liability be presented in profit or loss. As described in Agenda paper 3, accounting mismatches could arise between insurance liabilities measured in accordance with the proposed model and financial assets that are measured at amortised cost under IFRS 9 (and current US GAAP but not under the proposed ASU). Although IFRS 9 and US GAAP permits entities to measure all financial assets at fair value, some insurers do not think that doing so would result in more useful information and are concerned that it would be hard to explain the resulting volatile movements in the financial statements. Furthermore, they argue that their position may be unfairly presented when compared to financial institutions that use amortised cost to measure financial assets and liabilities arising from deposit-taking and lending activities.

2. The objective of this session is to consider whether there are alternatives that would better present the effect of volatility in other comprehensive income and mitigate accounting mismatches. This paper does not discuss the overall presentation model proposed in the exposure draft (ie the allocated premium approach for specified short-duration contracts and the summarised margin approach for the other insurance contracts), which is the subject of Agenda paper 9.

Shadow accounting

3. Some jurisdictions currently use shadow accounting (in various forms) to present insurance activities. Shadow accounting is an approach in which a

recognised but unrealised gain or loss on an investment asset affects the measurement of insurance liabilities (or related deferred acquisition costs) in the same way as a realised gain or loss. Thus, if unrealised gains or losses are recognised directly in equity (other comprehensive income), the related adjustment to the insurance liability or deferred acquisition costs is also recognised in equity.

4. Some would like the board to permit entities to continue using shadow accounting. Typically, they propose that the Board continues to permit use of the available–for-sale category for financial assets and permit some of the changes in the insurance liabilities to be recognised the same way as those assets. The IASB considered this proposal when it developed the requirements for financial assets in IFRS 9 *Financial Instruments*, but concluded that the simplification achieved by the two classification category approach for financial assets in IFRS 9 would provide more useful information.

5. Shadow accounting as described in paragraph 3 is no longer applicable under IFRS 9. Nevertheless, this paper considers whether a form of shadow accounting should be considered.

Separate presentation in the statement of other comprehensive income

6. Currently individual projects determine whether items should be presented in OCI. Accordingly, some suggest that the Board explores presentation alternatives that use other comprehensive income (OCI) to segregate the effects of any accounting mismatch for insurers. There are several variations, as described in paragraphs 7-11.

Specified changes in insurance liabilities

7. Under this approach, entities would present changes in the insurance liability resulting from changes in specified variables in OCI. Candidates for this approach are:

    (a) non-observable variables (eg liquidity adjustment, risk adjustment). Some think it would be useful to present effects of changes in non-observable variables in OCI because such variables are subjective. These variables may vary according to jurisdictions;

(b) financial variables (eg interest rates, changes in markets). Some think that variables that reflect short-term market fluctuations (eg financial variables) should be presented in OCI because those fluctuations do not reflect the entity's performance; or

(c) non-financial variables (eg mortality, changes in policyholder behaviour, risk adjustment). Some think that effects of changes in financial variables should be presented in the same part of the statement of comprehensive income for both financial assets and insurance liabilities—profit or loss. They believe that presentation of the effects of changes in non-financial variables on the insurance liabilities is more appropriate in OCI because those variables do not affect the values of the insurer's financial assets.[1]

8. All the above alternatives approach would require defining the variables (eg non-observable) for which changes are presented in other comprehensive income.

9. However, presenting changes in the insurance liability resulting from changes in specified variables in OCI has the following issues:

   (a) mismatches could arise if corresponding changes in the assets are presented in the profit and loss under alternatives (a) and (b) in paragraph 7.

   (b) many proponents of this approach would also prefer that these gains and losses to be 'recycled' in profit and loss, ie when the insurance liability is derecognised.

Parallel reporting of changes in assets

10. In this approach, entities would be required to present changes in the insurance liability in either profit or loss or OCI depending on where it presented the related changes in the assets measured at fair value. For example, if the insurer chooses to present changes in the fair value of investments in equity instruments

[1] For some jurisdictions, the differences between alternatives (a) and (c) may be minimal.

in OCI; then the corresponding changes in the insurance liability would also be presented there.

11. However, this approach would require entities to identify insurance liabilities that correspond to financial assets measured at fair value with changes in OCI and this may well be difficult. Furthermore, many would support this approach only if the amounts presented in OCI for both assets and liabilities are recycled to profit and loss. However, IFRS 9 prohibits recycling of changes in the fair value of investments in equity instruments.

Questions

Q1. How should changes in insurance contracts be presented so that accounting mismatches are minimised? What are the advantages of your approach?

Q2. If you think some changes in the insurance liability resulting from specified variables should be presented in OCI:
(a) which variables and why?
(b) would you recycle those changes? If so, under what conditions?
(c) should this be required or permitted?

Q3. If you think entities should present changes in the insurance liability in either profit or loss or OCI depending on where it presents the related changes in the assets measured at fair value, how would you identify the corresponding assets?