IASB Agenda ref 2

FASB Agenda ref 95

STAFF PAPER

IASB | FASB Meeting

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Project	Insurance contracts		
Paper topic	Cover note: Background information and progress report		
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1. This paper:

    a. Provides background information about the insurance contracts project (paragraphs 4-47)

    b. Summarises the boards' progress in the insurance contracts project (paragraphs 48-52).

    c. Provides an overview of agenda paper 2A/95A, together with a summary of the staff recommendation. This paper asks the boards for decisions about the discount rate for universal life and other contracts with participating features with no contractual linkage to underlying items (paragraphs 53-55).

    d. Describes next steps towards issuing a new standard on insurance contracts (paragraphs 56-60).

2. The IASB only papers discuss the IASB-only issues on presentation and disclosure and field testing. The overview and summary of the recommendations is included in agenda paper 3.

3. The Appendix provides a summary of previous decisions taken by the boards and describes what is still to come.

A reminder: why develop a building block approach?

4. The business model of an insurance company is to write contracts today that for which it will not know the profit for many years. This is almost unique and inevitably results in complex accounting that depends heavily on assumptions. In addition, many insurance products are often deliberately complex either for tax or competition purposes. While accounting standards can exacerbate the complexity, no accounting standard will remove this basic and key complexity, or the need to rely on assumptions about the future.

5. At the most basic level, insurers receive cash in the form of premiums, invest that cash into assets (generally financial assets) and promise to pay cash to the policyholder if insured event happens, sometimes many years in the future. In addition, many insurance contracts create complex interdependencies between rights and obligations that make them difficult to account for using existing standards. The difficulties of applying generally applicable standards include:

    a. Interdependencies between rights and obligations can make it difficult to identify the various performance obligations provided by the contract or to allocate the consideration paid by policyholders to those individual performance obligations.

    b. Uncertainty of outcomes can make it difficult to make estimates reliably and options and guarantees can exacerbate the uncertainty of outcomes. There can be significant changes in the cash flows that would be needed to fulfil the contracts.

    c. Long durations can mean that estimates made at the inception of a contract may not provide useful information throughout the life of the contract. Furthermore, there is little ability to assess whether estimates made at inception were reasonable or accurate.

6. The boards' standard on insurance contracts is intended to address some of these difficulties. In undertaking this project, the boards intended to base their respective standards for insurance contracts on:

a. a coherent framework for all types of insurance contracts. This would eliminate much of the complexity that arises from the many and overlapping accounting models that have been developed in many jurisdictions to reflect the different ways in which insurers make money.

b. the current measurement of the insurance contracts liability, incorporating a current, unbiased estimate of the cash flows expected to fulfil the liability, an adjustment to reflect the time value of money (and, for the IASB, to reflect the effect of risk and uncertainty). This would provide more timely information over the life of the contract, as estimates and expectations change. The insurance contract liability should be calibrated at inception to the premium.

Coherent framework for all insurance contracts

7. The building block approach is useful to reflect the many different ways in which insurers make money whether through fees from asset management services, investment income from spread business or underwriting profit from protection business.

8. Some insurance contracts are predominantly focused on one type of activity, for example, many non-life contracts are focused on providing risk protection. Similarly, guaranteed savings products focus on investment returns, and unit-linked policies are principally focused on fee income. However, most insurance contracts blend different activities in different proportions and sometimes the importance of those activities varies over the life of a contract. This means that insurance contracts can expose the insurer to a spectrum of risk, including financial markets risk. For example, consider an account-driven contract with a guaranteed minimum death benefit. In the early stages of the contract, the risk undertaken in providing the death benefit is most significant. However, as the account balance builds up, the death benefit becomes less significant and the investment return and asset spreads become more relevant.

9. 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 liability reflects those features as appropriate, without creating the discontinuities (or 'cliff effects') that would occur if different models were used to reflect the different features. Thus:

   a. For short duration contracts, the main driver of the insurance contract liability is the cash flows (and risk associated with those cash flows). If the building block approach is applied to short duration contracts, the residual margin would exist only during the coverage period. During the coverage period, it is unlikely that the initial estimate of the liability will change significantly during that period and the residual margin and risk adjustment are likely to be released reasonably evenly over time. This is represented in the allocation of the premium over time. After the coverage period:

      (i) For short-tail contracts, discounting would be less significant, and may be immaterial. In addition, there is little potential for changes in the risk adjustment in the liability for incurred claims.

      (ii) For long-tail contracts, discounting would be more significant. The amount of risk and potential for changes in the risk adjustment in the liability for incurred claims would also be more significant.

   b. Longer duration contracts generally mix investment and risk to a greater extent.

      (iii) For annuity contracts and term life contracts, initial expectations of the risk in a portfolio of contracts may not vary significantly over the life of the contract. Thus, changes in the risk adjustment would be less significant (although it may be a significant component at inception) and discounting and estimates of cash flows (eg resulting from mortality and lapse assumptions) would be significant.

(iv) For participating contracts, the risks in the investment components and perhaps also the insurance components are passed to the policyholder to some extent. However, the estimates of cash flows arising from guarantees and the discounting of those cash flows remain significant.

10. In the past, accounting models have evolved to address the specific needs of the contract being considered. However, this creates problems when insurance contracts combine elements typically found in different types of contracts. For example, some property-casualty contracts may specify the payment of annuity payments, rather than a single lump sum. Such contracts combine underwriting risk (ie whether the insured event will occur) and investment risk (after the insured event occurs). If different accounting models are applied to underwriting risk and investment risk, it would not be clear which model to apply to such a contract. A comprehensive framework for insurance contracts avoids that problem.

11. At their February 2012 joint meeting:

    a. the IASB tentatively decided that contracts should be eligible for the premium allocation approach if that approach would produce measurements that are a reasonable approximation to those that would be produced by the building block approach. Thus, the IASB confirmed its view that there should be a single accounting model for all types of insurance contracts.

    b. the FASB tentatively decided that insurers would be required to apply the premium allocation approach for contracts that meet specified criteria. Thus, the FASB confirmed its view that there should be two accounting models for two different types of insurance contracts.

The accounting model developed by the boards

12. The accounting model developed by the boards proposed a current value measurement model that uses updated estimates and assumptions, using market-consistent information where available, and that reflects the time value of money and differences in uncertainty relating to the liability. In substance, the boards have confirmed the measurement model for insurance contract liabilities that it was proposed in the ED.

Current measurement of the insurance contracts liability

13. The use of a current value measurement model for the insurance contracts liability is necessary for three important reasons:
    a. It provides transparent reporting of changes in the insurance contract liability and provides complete information about changes in estimates.
    b. It results in transparent reporting of the economic value of options and guarantees embedded in insurance contracts.
    c. It means that the assets and liabilities of an insurer are measured on consistent basis, thus reducing accounting mismatch in comprehensive income and equity.
14. However, in a current measurement model, reported volatility can arise if there are economic or accounting mismatches. In other words, volatility arises:
    a. if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. Such **economic** mismatches may result in reported volatility which we believe faithfully represents the underlying economics.
    b. if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because they are measured on different bases. We seek to eliminate such **accounting mismatches.**

15. We believe that when an insurer has an economic mismatch, market fluctuations give rise to real economic effects. When combined with a current measurement of the assets, a current measurement of the liability portrays those effects. Such economic mismatches include:

    a. Changes in expected credit losses on assets if those credit losses do not affect the amounts payable to policyholders.

    b. Changes in the risk premium that investors charge for bearing the risk that credit losses might exceed expectations if those credit losses do not affect the amounts payable to policyholders

    c. Changes in the premium that investors pay (by receiving a reduced return) to invest in assets that provide liquidity, if the amounts paid to policyholders do not include a similar reduction because the liabilities do not provide similar liquidity for policyholders.

    d. Duration mismatches between assets and liabilities.

    e. Any guarantees written by the insurer, eg a requirement that the insurer will pay policyholders the higher of a return based on actual asset returns and a specified minimum return.

16. Furthermore, we believe that volatility in itself is not undesirable as long as the source of volatility can be understood and clearly related to economic phenomena. However, volatility that arises only from accounting mismatch does not provide a faithful representation of the underlying economic phenomena.

17. The current measurement of the insurance contract liability would eliminate a significant accounting mismatch from the statement of comprehensive income and from equity if the insurer measures the assets it holds to back its insurance contract liability at fair value. Furthermore, the ‘mirroring approach’ for participating contracts introduced by the boards prevents an accounting mismatch in comprehensive income and in equity between assets and liabilities that are contractually linked. The mirroring approach also means that, when permitted by existing accounting treatments, insurers could use cost-based

measurements for the items underlying the policyholder participation, without creating an accounting mismatch.

18. In addition, even if mismatches in measurement have been eliminated, mismatches can arise in presentation. Thus mismatches occur if the changes in the carrying amounts of assets are presented in profit and loss and changes in the carrying amount of liabilities are presented in OCI or vice versa. Because the boards propose that some changes in the insurance contract liability should be presented in other comprehensive income, mismatches in profit and loss can arise if the insurer's assets are measured at fair value through profit and loss or at amortised cost. When such volatility is unavoidable, we seek to ensure sufficient information is given to permit users of financial statements to understand the source of such volatility

Information about the components of the insurance contracts liability

19. A key advantage of the building block approach is that it provides transparent information about the way that changes in the different components of the insurance contracts liability affect the measurement of the liability. Thus changes in expectations of cash flows are identified separately from changes that arise from the discount rate (and, for the IASB, from changes in the amount of risk).

20. However, separating the components of the insurance contracts liability can provide operational challenges, particularly because the components are not directly observable. In the comment letters to the IASB's exposure draft and the FASB's discussion paper, some noted difficulty in determining a discount rate that reflects only the characteristics of the liability. Accordingly, the boards provided additional clarification about how an insurer should determine the discount rate used to discount the liability cash flows, as follows:

    a. The boards confirmed that a top-down approach to determining the discount rate would meet the objective for determining the discount rate.

b. We provided clarification that if there are no observable inputs (eg market data) for determining the discount rate, the insurer shall use an estimate that is consistent with the boards' guidance on fair value measurement, in particular fair value measurements categorised within Level 3 of the fair value hierarchy.

21. Those clarifications also had the effect of reducing the amount of reported volatility. In particular, the top-down approach would significantly reduce accounting mismatch arising from credit spread changes because it adjusts a reference rate in a way that eliminates from that rate factors that are not relevant to the insurance contract liability. However, in a top-down approach, an insurer need not make adjustments for some differences between the liquidity inherent in the liability cash flows and the liquidity interest in the asset cash flows. This means that the effect of liquidity spread changes would affect the measurement of both the assets and the liability. Thus, to the extent that an insurer is duration matched, and changes in spreads are driven by liquidity or sentiment, then this eliminates the effect of spread changes from profit and loss. This removes a portion of the volatility from the changes in bond yields, compared to the 'bottom-up' approach that most respondents interpreted the ED/DP to require. However, it does not eliminate the effect of estimated credit defaults.

22. Applying the guidance on fair value measurement, an insurer would adjust an observable input if that input relates to a liability whose characteristics differ from the characteristics of the liability being measured. Because forecasts of unobservable inputs tend to put more weight on longer 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.

Representation of the unearned profit in the contract

23. The IASB and the FASB's models have two key differences in the representation of the profit the insurer earns over the life of the contract:

a. The IASB’s model includes an explicit risk adjustment in the measurement of the insurance contract liability and allocates the residual margin on a systematic basis in line with the pattern of services provided under the contract. This means that two drivers determine the amount of profit recognised in an accounting period. This approach reflects a view that the insurer may earn profit from the contract in more than one way. In contrast, in the FASB’s single margin approach the single margin is viewed as unearned profit that should not be recognised until the associated cash flows become more certain. Risk, taken in conjunction with entity-specific factors, is the primary driver for the release of the whole of the single margin. Thus, in the FASB’s model the whole of the profit in the contract is released to profit and loss as an insurer is released from exposure to risk as evidenced by a reduction in the variability of cash flows.

b. In the IASB’s model a net increase in expected future outflows is offset against the residual margin and a net decrease in expected future outflows is added to the residual margin[1]. Consequently, a decrease (or increase) in the contract’s expected profitability arising from changes in estimates of future cash flows would not be recognised immediately[2] (except to the extent that a decrease exceeded the residual margin available for offset, i.e. if the contract became onerous). It would be recognised in subsequent periods, when the residual margin is released to profit or loss. This is commonly referred to as ‘unlocking’. In contrast, in the FASB’s model, all changes in estimates are recognised immediately in profit and loss and as an adjustment to the insurance liability (unless the contract is onerous).

[1] Experience adjustments that relate to past events would be recognised immediately in profit or loss.
[2] However, that change would be disclosed in roll forwards in the notes to the financial statements.

Risk adjustment

24. The IASB's risk adjustment approach remeasures the explicit risk adjustment through profit and loss each reporting period to reflect increases and decreases in risk when such changes are significant, for example when:
    a. There is a significant change in expected risk, for instance the start of a pandemic.
    b. The outcome is inherently uncertain (ie high severity, low frequency contracts).
25. In contrast, the FASB's single margin approach, the single margin reflects decreases in risk as the single margin is amortised and is not remeasured unless a portfolio of insurance contracts is deemed onerous.
26. This difference in remeasurement would not result in differences in the accounting for many contracts, for example where estimated uncertainty about the occurrence or non-occurrence of the insured event and the eventual claim amount will not vary significantly over the coverage and settlement period (eg a 10-year term life contract, where the risks are stable and relatively low). For such contracts, risk would generally decrease in a predictable way over the coverage period.
27. However, the difference in remeasurement under the two approaches would create significant differences in the accounting for contracts where uncertainty about the occurrence or non-occurrence of the insured event and the eventual claim amount can vary significantly over the coverage period (eg insurance cover for asbestosis, where the risk increased significantly in the settlement period).
28. A further difference between the IASB and FASB's models is in the drivers of profit recognition.
29. In the IASB's model there are two drivers of profitability. The risk adjustment is released and recognised in profit or loss as the insurer is released from risk, and the residual margin is allocated to profit or loss on a systematic basis in line with the pattern of services provided under the contract.

30. In contrast, in the FASB's model the single margin (part of which is equivalent to the residual margin) is allocated in line with the release from risk. Thus, risk is regarded as the main driver of profitability. The single margin is released over the coverage and settlement periods in the building block approach. The implicit single margin is released over the coverage period only in the premium allocation approach.

31. This difference in the release pattern would not result in different accounting treatment for contracts that are predominantly driven by insurance risk, especially contracts of a shorter coverage period (eg most nonlife contracts). However, the difference in the release pattern under the two approaches would result in different accounting treatment for life contracts that have a large investment component relative to the insurance risk. The service under such contracts may not be provided in the same pattern as the risk in the contract (for example, for some regular premium contracts, the service is predominantly asset management and can increase over time).

Offsetting changes in the margin

32. The FASB's approach to changes in estimates is consistent with the IASB's ED, and reflects the view that a current measure of the insurance liability is integral to understanding and reporting insurance contracts, and that the immediate recognition of all changes in estimates provides important information to users about changes in circumstances for insurance contracts.

33. However, in response to the comment letters the IASB revised its preliminary view because it was persuaded that offsetting changes in estimates of future cash flows would provide better information for users of financial statements. The reasons are:

    a. It would reflect a view of the residual margin as the unearned profit in the contract. Applying this view, the residual margin should be measured as the difference between the premiums and the estimates of the cash outflows. If the cash outflows increase, the contract becomes less profitable and the residual margin decreases accordingly. If the increase relates to estimates of future cash flows (as opposed to experience adjustments), the increase reduces the unearned component of the residual margin. Consequently a change in the estimate of the future cash flows should be viewed as a transfer between the components of the total liability, i.e. offset against the residual margin.

b. It would avoid outcomes that some people regard as counterintuitive. Immediate recognise of adverse changes in estimates can make contracts that are profitable overall appear to be loss-making in some years. It can also make contracts that actually become loss-making overall appear to be profitable in later years.

c. An approach that offsets changes in estimates against the residual margin could help prevent manipulation of profits. Applying the original proposals, an insurer might over-estimate the fulfilment cash flows on ‘day 1’ of the contract. On ‘day 2’ it could revise the estimates down and recognise the difference as an immediate gain. In contrast, applying the revised approach, the insurer would recognise the difference as an adjustment to the residual margin. The outcome would be the same as if the insurer had correctly estimated the fulfilment cash flows on day 1. The insurer would not recognise an immediate gain.

34. An effect of ‘unlocking’ the residual margin in the manner summarised in the previous paragraph is that it ‘locks’ the liability as a whole (except to the extent that the contract becomes onerous). The liability is locked at an amount equal to the premiums received from the policyholder for services not yet provided. Thus, the effect of ‘unlocking’ the residual margin is to make the building block approach more like the model proposed in the revenue recognition project.

Presentation in the statement of comprehensive income

Presentation of revenue and expenses

35. The 2010 exposure draft proposed a summarised margin presentation approach in the statement of comprehensive income. The summarised margin approach would require presentation of the sources of change in the insurance liability, but it would not require presentation of premiums, claims or benefits.

36. Respondents to the exposure draft, including many users, requested a statement of comprehensive income that would be more consistent with those of other industries. That view was supported in the outreach meetings conducted with users across the world. Accordingly, the boards decided that insurers should present information about premiums, claims and expenses that would be consistent with the general revenue recognition principles that the boards are developing in their project on revenue recognition.

37. We believe that presentation of revenue and expenses under the earned premium approach consistent with commonly understood notions of revenue and expenses will assist non-specialist users of financial statements in understanding and analysing an insurer’s business.

38. However, we noted the perceived complexity of providing revenue information for insurance contracts and plan to consult whether the costs of that complexity outweigh the benefits of providing such information.

Presentation of changes in the measurement of the insurance contract liability

39. As noted in paragraph 8, there are significant differences in the sources of earnings for the different types of insurance contracts. Underwriting is typically regarded as dominant for non-life insurance. However profit from mortality protection products stems mainly from the difference between anticipated and actual mortality, and hence underwriting is also critical to those contracts. Annuity products offer mainly longevity protection, and both underwriting and investment results are important. For savings products with minimum return

guarantees, investment income is most important. For savings products where investment risks are borne by the policyholder, fee income is most important.

40. Furthermore, the sources of earnings are susceptible to different degrees of volatility as follows:

    a. The underwriting result, although variable over time is typically a less volatile contributor to profit than the investment result.

    b. Fees for managing policyholder assets tend to fluctuate with the value of assets under management and tend to be more volatile.

    c. Investment returns are correlated with financial market performance, which can be extremely volatile, particularly in recent years.

41. We sought to display the different sources of an insurer's earnings and to present changes in the insurance liability in a way that provides useful information to users. We believe that information is useful when:

    a. Underwriting performance is presented clearly and not overshadowed by other information

    b. Changes in the insurance liability that reverse over time are presented separately from other changes

    c. Accounting mismatches are eliminated or reduced, to the extent possible.

42. Therefore we introduced a requirement that insurers should segregate in OCI changes in the insurance contract liability arising from changes in the discount rate. This means that an insurer would:

    a. Present underwriting performance in profit and loss, segregated from changes that arise from interest rate movements which it would present OCI.

    b. Present in profit and loss locked in information (analogous to cost for financial assets and financial liabilities) and present in OCI current value information.

43. We noted that the requirement to present changes in the insurance contract liability in OCI would introduce an accounting mismatch in profit and loss if there is no contractual link between the insurer's assets and the insurance contracts liabilities, and if the insurer's assets are accounted for at fair value through profit and loss. However, our decision arises from trying to improve comparability and minimize the complexity in using OCI when insurers hold portfolios of assets with mixed measurement attributes. We believe this mismatch is unavoidable, unless insurers hold substantially all of their assets at fair value through profit and loss.

44. Therefore we think that a full picture of an insurer's performance can only be gained by considering all components of total comprehensive income, including those components included in profit and loss and those included in OCI.

45. For contracts which create a contractual link between the underlying items and the insurance contract liabilities, the boards' decision that to 'mirror' the measurement and presentation of the assets in measuring and presenting the liabilities means that the mismatch referred to in paragraph 43 does not arise.

What would change for current practice

46. Because different accounting models have evolved in different jurisdictions and at different times to address the products most prevalent in their jurisdictions, the boards' proposals would affect different jurisdictions in different ways. However, in the main, there will be relatively little change for many non-life contracts. The main changes for non-life are:

    a. The requirement to use expected value to measure the liability for incurred claims, rather than best estimates or other methods.

    b. The introduction of discounting (and risk adjustment for IASB) in measuring the liability for incurred claims.

    c. More information in the financial statements about claims liabilities, changes in risk and effects of discounting.

47. For life contracts, there is more significant divergence today and more significant changes would result from the standard. The main changes are:

    a. Updated assumptions rather than locked-in assumptions.

    b. Information about the time value and the intrinsic value of guarantees and options embedded in insurance contracts on a basis consistent with market information. Previously many accounting models provided no or incomplete information about the time value or intrinsic value of some or all embedded options or guarantees. As a result, users of financial statements were sometimes not informed about the potential effect of embedded options or guarantees until such options and guarantees were in the money.

    c. More information about assumptions and effects of assumptions including risk and effects of discounting.

    d. A discount rate that reflects the features of the insurance liability, rather than one that reflects the features of the assets backing that liability. The resulting measurement of the liability will not be reduced by hoped-for investment spreads.

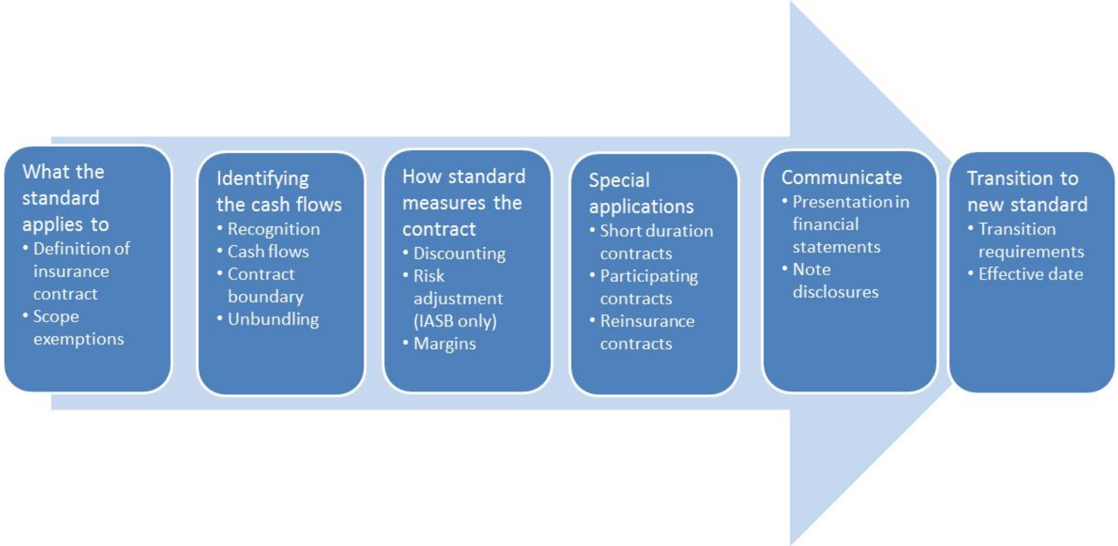
    e. More transparent information about changes in estimates.

    f. Cash flows used to measure insurance contracts would include acquisition costs. As a result, there would be no need to defer acquisition costs, and no need for complex and hard-to-understand mechanisms for dealing with that deferral.

    g. One accounting model for all life insurance contracts, rather than different accounting models based on product type.

Where we are in the project

48. The ED/DP contained proposals for a standard on insurance contracts as follows:



49. This section summarises our progress in redebating those proposals. Further details are in the appendix.

Tentative decisions so far

50. We have substantially completed the tentative decisions relating to the measurement and presentation of the insurance contract liability. In reaching these decisions, the boards have reached converged decisions in many key areas, notably that an insurer should:

    a. measure insurance contracts on the basis of all the cash flows expected to arise as the insurer fulfils the contract, adjusted to reflect any contractual linkage between the contract and any underlying assets.

    b. discount those cash flows using a rate that reflects only the characteristics of the liability.

    c. measure insurance contracts using updated estimates and assumptions and, where available, estimates consistent with prices in financial markets.

    d. not recognise gains at inception of insurance contracts.

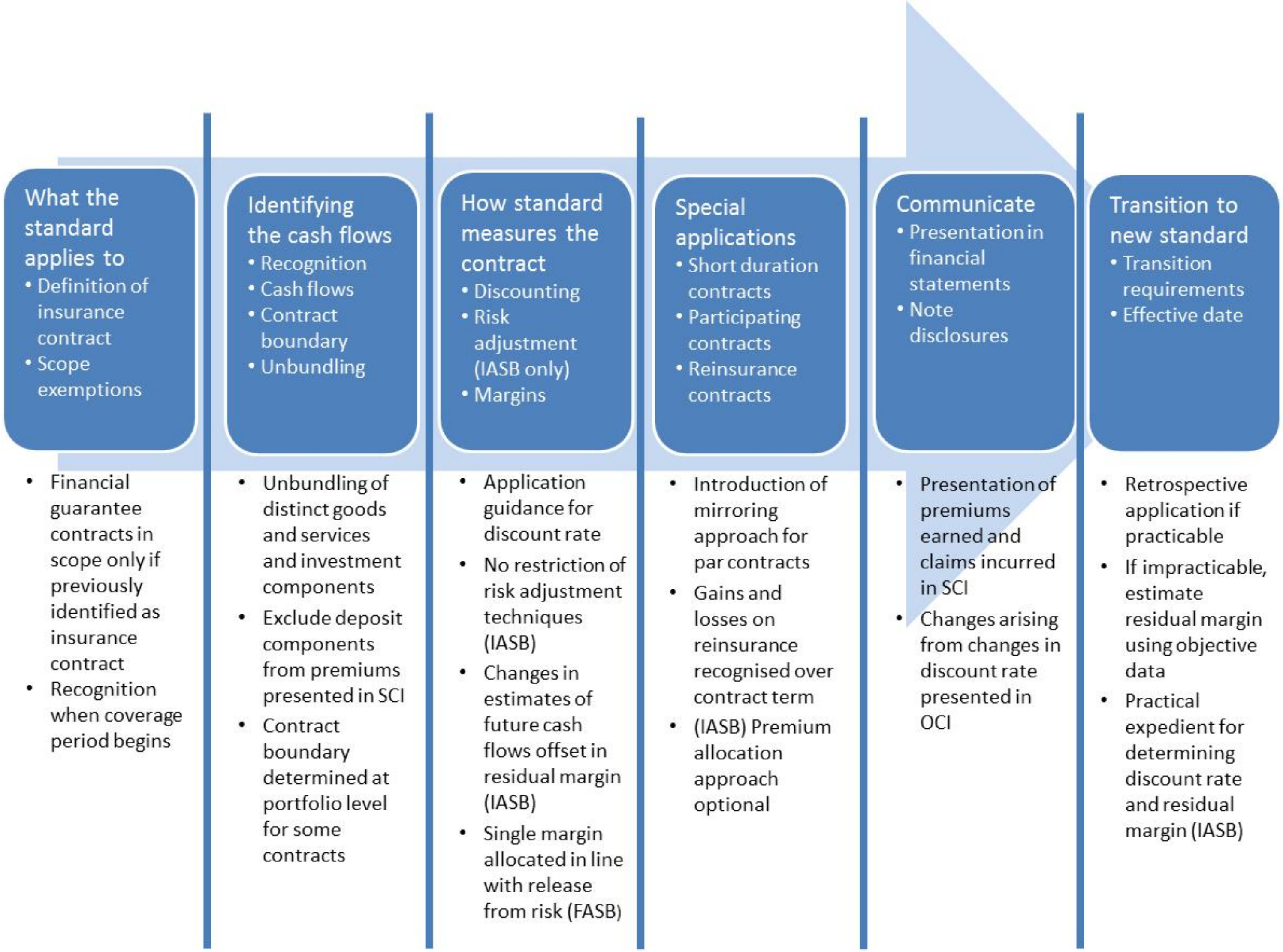
    e. present financial statements in a way that shows information about key drivers of profitability.

f. Present revenue on an earned basis and claims on an incurred basis, using the measurement of the insurance contracts liability as a measure of progress towards satisfaction of the insurer's performance obligations.

51. In addition, the boards have common decisions on the mechanics of the premium allocation approach. The premium allocation approach would, in general, be applied to the measurement of the liability for remaining coverage of contracts with a coverage period of one year or less or contracts that meet specified criteria.

Summary of changes since the ED

52. The diagram on the following page summarises the main changes from the ED. Further details of the boards' tentative decisions are given in the Appendix.


What the standard applies to
• Definition of insurance contract
• Scope exemptions
Identifying the cash flows
• Recognition
• Cash flows
• Contract boundary
• Unbundling
How standard measures the contract
• Discounting
• Risk adjustment (IASB only)
• Margins
Special applications
• Short duration contracts
• Participating contracts
• Reinsurance contracts
Communicate
• Presentation in financial statements
• Note disclosures
Transition to new standard
• Transition requirements
• Effective date
• Financial guarantee contracts in scope only if previously identified as insurance contract
• Recognition when coverage period begins
• Unbundling of distinct goods and services and investment components
• Exclude deposit components from premiums presented in SCI
• Contract boundary determined at portfolio level for some contracts
• Application guidance for discount rate
• No restriction of risk adjustment techniques (IASB)
• Changes in estimates of future cash flows offset in residual margin (IASB)
• Single margin allocated in line with release from risk (FASB)
• Introduction of mirroring approach for par contracts
• Gains and losses on reinsurance recognised over contract term
• (IASB) Premium allocation approach optional
• Presentation of premiums earned and claims incurred in SCI
• Changes arising from changes in discount rate presented in OCI
• Retrospective application if practicable
• If impracticable, estimate residual margin using objective data
• Practical expedient for determining discount rate and residual margin (IASB)

Overview of papers for this meeting

53. There is one paper for the joint meeting: Agenda paper 2A/95A *Discount rate—cash flows to which mirroring does not apply but are affected by expected asset returns.* This paper considers the treatment of contract whose cash flows are affected by expected asset returns, but for which the mirroring approach does not apply. For those contracts, the staff propose to:

    a. clarify how the tentative decisions made to date regarding the discount rate might be applied to cash flows that are affected by expected asset returns.

    b. consider whether, and if so, when, the discount rate used to present interest expense in profit or loss should be reset from the discount rate at inception of the insurance contract. Based on tentative decisions, the interest expense in profit loss is presented using the discount rate at inception.

54. The paper recommends that for contracts whose cash flows are affected by asset returns and for which the mirroring approach does not apply:

    a. The boards should clarify that the discount rate that reflects the characteristics of the contract's cash flows shall reflect the extent to which the estimated cash flows are affected by the return from those assets. This would be the case regardless of whether the:

        (i) transfer of the expected returns of those assets are the result of the exercise of insurer's discretion; or

        (ii) the specified assets are not held by the insurer.

    b. Upon any change in expectations of the crediting rate used to measure the insurance contracts liability, an insurer shall reset the locked-in discount rate that is used to present interest expense.

IASB papers

55. In addition, the IASB will consider papers on presentation and disclosure and field testing. Agenda paper 3 summarises the content and the staff recommendations for those papers.

Next steps

Remaining topics

56. The boards plan to continue to debate follow up issues on the earned premium presentation and may consider sweep issues jointly if appropriate. The boards also have topics that they plan to consider separately.

57. For the FASB, those topics include:

    a. *Whether financial guarantee contracts are within the scope of the insurance contracts standard.* The IASB tentatively decided to carry forward the existing exemption in IFRS 4 that permits an insurer to account for some financial guarantee contracts in accordance with financial instruments standards.

    b. *Contract modification.* The FASB staff plan to consider which additional circumstances will result in derecognition and whether there needs to be application guidance. The IASB has tentatively decided that an insurer shall derecognise an existing contract and recognise a new contract if it amends the contract in a way that would have resulted in the contract being included in a different portfolio than the one in which it was included at initial recognition.

    c. *Embedded derivatives.*

    d. *Disclosures:* The FASB plan to conduct workshops on disclosures before concluding on disclosures at a future meeting. The IASB substantially completed its decisions on disclosures at the September 2012 meeting.

58. For the IASB this includes:

   a. *Follow up issues on unlocking the residual margin.* This topic is not relevant to the FASB. The IASB staff plan to consider further details about how to unlock the residual margin to be consistent with the IASB's view of the residual margin as the unearned profit in the insurance contract

   b. *Industry proposals for a floating residual margin:* The IASB staff plan to discuss industry proposals for participating contracts that build upon its tentative decisions that the residual margin should be unlocked.

Due process document

59. At their September 2012 meeting, the IASB decided that it would re-expose its proposals and seek constituent feedback only on the following views:

   a. the requirement that the cash flows used to measure participating contracts should be based on the cash flows used to account for the underlying items;

   b. the requirement to present premiums in the statement of comprehensive income, which has two consequential decisions:

      (i) the part of the premium that relates to investment components is excluded from the premium presented in the statement of comprehensive income

      (ii) the premiums are allocated in the statement of comprehensive income on an earned basis.

   c. the requirement to use the residual margin to offset changes in estimates of future cash flows;

   d. the requirement to present in other comprehensive income changes in the discount rate used to measure the insurance contract liability; and

   e. the proposed transition requirements, including the tentative decisions made at the joint meetings in September and October.

The IASB intends to publish this Exposure Draft in the first half of 2013.

60. For the FASB, the next due process document will be an exposure draft and the FASB expects to publish this in the first half of 2013.

Appendix: Detailed progress report

The following table summarises the progress the boards have made and describes what is still to come. Main changes since AP2/90 for the October meeting are marked (new text underlined, deleted text struck-through).

	Topic	Tentative decisions	Open points
		Building block 1 – Which cash flows?	
1.	Recognition point	• Recognise insurance contract assets and liabilities when the coverage period begins, unless facts and circumstances indicate that contract might be onerous. • A cedant should recognise a reinsurance asset: o when the reinsurance contract coverage period begins, if the reinsurance coverage is based on aggregate losses of the portfolio of underlying contracts covered by the reinsurance contract. o when the underlying contract is recognised, in all other cases. • Acquisition costs incurred before a contract's coverage period begins should be recognised as part of the insurance contracts liability for the portfolio of contracts where the contract will be recognised once the coverage period begins. • <u>**[IASB only]** An entity shall recognise a financial instrument with a discretionary participation feature only when the entity becomes a party to the contractual provisions of the instrument, eg when the entity is contractually obliged to deliver cash</u>	
2.	Contract boundary	• Contract renewals should be treated as a new contract: o when the insurer is no longer required to provide coverage; or o when the existing contract does not confer any substantive rights on the policyholder. • A contract does not confer on the policyholder any substantive rights when the insurer	

	Topic	Tentative decisions	Open points

		has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
		• In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.
		• All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation.
		• <u>**[IASB only:]** For financial instruments with discretionary participation features, the contract boundary is the point at which the contract no longer confers substantive rights on the contract holder. A contract no longer confers substantive rights on the contract holder when:</u>
		  • <u>the contract holder no longer has a contractual right to receive benefits arising from the discretionary participation feature in that contract; or</u>
		  • <u>the premiums charged confer upon the contract holder substantially the same benefits as those that are available, on the same terms, to those that are not yet contract holders.</u>	

3.	Fulfilment cash flows – objective	Expected value, with guidance that: • expected value refers to the mean that considers all relevant information; and • not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the measurement objective of determining the mean. • if an insured event (for example an infrequent, high-severity event such as a hurricane) was impending at the end of the reporting period and subsequently occurs (or does not occur), that subsequent occurrence (or non-occurrence) does not constitute evidence of a condition that existed at the end of the reporting period (non-adjusting event	

	Topic	Tentative decisions	Open points
		according to IAS 10).	
4.	Fulfilment cash flows – which cash flows	• Include all costs that the insurer will incur directly as it fulfils the contracts in that portfolio, ie: o costs that relate directly to the fulfilment of the contracts in the portfolio; o costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and o such other costs as are specifically chargeable to the policyholder under the terms of the contract. • Exclude costs that do not relate directly to the insurance contracts or contract activities, which should be recognised as expenses in the period in which they are incurred.	• Treatment of taxes paid on behalf of policyholders

	Topic	Tentative decisions	Open points
5.	Acquisition costs	Include in fulfilment cash flows all the direct costs that the insurer necessarily incurs in acquiring the contracts in the portfolio, and exclude indirect costs such as: • software dedicated to contract acquisition • equipment maintenance and depreciation • agent and sales staff recruiting and training • administration • rent and occupancy • utilities • other general overhead • advertising. ***[FASB only]***: additionally exclude the costs necessarily incurred in acquiring the contracts in the portfolio but deemed to relate to unsuccessful acquisition efforts. ***[FASB only]***: direct-response advertising costs should be expensed as incurred consistent with other forms of advertising costs. <u>Recognise the cash flows relating to acquisition costs in the statement of comprehensive income in a way that is consistent with the proposed allocation of the residual/single margin. In other words:</u> • <u>For the IASB, in a way that is consistent with the pattern of transfer of services provided under the contract.</u> • <u>For the FASB, as the insurer satisfies its performance obligations to stand ready to compensate the policyholder if a specified uncertain future event adversely affects the policyholder, which is when the insurer is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. Consequently, the margin recognised should be grossed up for the amount of acquisition costs recognised.</u>	~~IASB: Whether to recognise acquisition costs as incurred or over the coverage period. If over the coverage period, the pattern for such recognition.~~ ~~FASB: The accounting treatment for acquisition costs. (However, the FASB tentatively decided against an approach that would require an insurer to expense the acquisition costs and recognise income equal to, and offsetting, those costs when the acquisition costs are incurred.)~~ ~~Recognition pattern for acquisition costs is discussed in joint AP 2C/90C for this meeting.~~

	Topic	Tentative decisions	Open points
	Building block 2 – Time value of money		
6.	Discounting	• Adjust the future cash flows for the time value of money using a current discount rate that reflects the characteristics of the insurance contract liability. That rate should be updated each reporting period • Discounting not required when the effect of discounting would be immaterial. • <u>An insurer should discount the liability for incurred claims in the premium allocation approach using the rate at the inception of the contract. That rate is locked in in presenting the interest expense.</u> • Practical expedient: An insurer that applies the premium allocation approach is permitted not to discount liabilities for incurred claims which are expected to be paid within 12 months. An insurer that elects to apply this practical expedient should use an undiscounted basis when identifying whether contracts are onerous and in measuring the liability for onerous contracts.	~~Discounting and interest accretion follow up issues for premium allocation approach is discussed in agenda paper 2D/90D for this meeting.~~
7.	Discount rate	(a) No prescribed method to determining the discount rate, but rate should: (i) be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk; (ii) exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability (eg risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed to the policyholder); and (iii) reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability. (iv) reflect any dependence between the amount, timing or uncertainty of the cash flows arising from an insurance contract and the performance of specific assets (ie for participating contracts).	<u>The discount rate used for universal life and other contracts with participating features with a contractual linkage to underlying items is discussed in agenda paper 2A/95A for this meeting.</u>

	Topic	Tentative decisions	Open points
		(b) Provide application guidance that the insurer determines the yield curve for the insurance contract liability based on a yield curve that reflects current market returns for either the actual portfolio of assets the insurer holds, or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability. In those cases, the insurer excludes from those rates factors that are not relevant to the insurance contract liability (a 'top-down' approach). In a 'top down' approach: (i) An insurer shall determine an appropriate yield curve based on current market information. (ii) If there are no observable market prices for some points on that yield curve, the insurer shall use an estimate that is consistent with the boards' guidance on fair value measurement, in particular for Level 3 fair value measurement. (iii) to determine the yield curve, the cash flows of the instruments shall be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. In adjusting the cash flows, the insurer shall make both of the following adjustments: (1) Type I, which adjust for differences between the timing of the cash flows to ensure that the durations of the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows. (2) Type II, which adjust for risks inherent in the assets that are not inherent in the liability. In the absence of an observable market risk premium for those risks, the entity uses an appropriate technique to determine that market risk premium, consistent with the objective for the discount rate, as stated above. (iv) an insurer using a 'top-down' approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in the asset cash flows.	

	Topic	Tentative decisions	Open points
		Building block 3 – Risk adjustment	
8.	Risk adjustment	***[IASB only]*:** (a) Measurement of an insurance contract should include an explicit adjustment for risk. That adjustment should be determined independently from the premium and re-measured in each reporting period. (b) The objective of risk adjustment should be to reflect the 'compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract', including the extent to which any diversification benefits affect the amount of compensation required. (c) No limit on the range of available techniques to determine the risk adjustment. (d) Application guidance: (i) the risk adjustment measures the compensation that the insurer would require to make it indifferent between (1) fulfilling an insurance contract liability which would have a range of possible outcomes or (2) fulfilling a fixed liability that has the same expected present value of cash flows as the insurance contract. For example, the risk adjustment would measure the compensation that the insurer would require to make it indifferent between (1) fulfilling a liability that has a 50% probability of being 90 and a 50% probability of being 110 or (2) fulfilling a liability of 100. (ii) in estimating the risk adjustment, the insurer should consider both favourable and unfavourable outcomes in a way that reflects its degree of risk aversion. A risk averse insurer would place more weight on unfavourable outcomes than on favourable ones. (iii) Retain the list of characteristics, proposed in paragraph of B72 of the ED, that a risk adjustment technique should exhibit if that technique is to meet the objective of the risk adjustment (iv) Retain as examples the three techniques proposed in the ED (confidence levels,	

	Topic	Tentative decisions	Open points
		conditional tail expectation and cost of capital), together with the related application guidance (e) Confirmed the confidence level equivalent disclosure that had been proposed in paragraph 90(b)(i) of the ED. ***[FASB only]*:** (f) Measurement of an insurance contract should use a single margin approach that recognises profit as the insurer satisfies its performance obligation to stand ready to compensate the policyholder if a specified uncertain future event adversely affects that policyholder.	
	Building block 4 – residual/single margin		
9.	Residual / single margin	• No gain at inception of an insurance contract. • Any loss on day one determined at portfolio level recognised immediately in profit or loss (net income). *For residual margin* ***[IASB only]*** • Changes in estimates for some cash flows offset prospectively in the residual margin (unlocking). • Changes in risk adjustment recognised in profit or loss in the period of the change. • Residual margin allocated over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract. • An insurer should accrete interest on the residual margin. • The rate used for the accretion of interest should be the discount rate of the liability determined at initial recognition, ie a locked-in rate. *For single margin* ***[FASB only]****:* • The single margin should be recognised as profit as the insurer satisfies its performance obligation to stand ready to compensate the policyholder if a specified uncertain future event adversely affects that policyholder, determined at portfolio level.	

	Topic	Tentative decisions	Open points
		• An insurer satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. • An insurer is released from risk on the basis of reduced uncertainty in the timing of the insured event and/or as variability in the cash flows is reduced as information about expected cash flows becomes more known throughout the life cycle of the contract. • An insurer should not remeasure or recalibrate the single margin to recapture previously recognised margin. • The single margin should not be unlocked for changes in actual or expected cash flows and, instead, such changes should be reported in the income statement immediately. • If an insurer determines that a portfolio of contracts is onerous, an additional liability (measured as the present value of future payments for benefits and related settlement and maintenance costs less the present value of future gross premiums less the insurance contract liability) should be recognized with a corresponding offset to eliminate any remaining margin. If the additional liability exceeds the remaining margin, an insurer would recognise an expense for the excess amount. • The write-off of the single margin on contracts deemed onerous may not be reversed in future periods.	
	Application guidance for building blocks		
10.	Participating features	• When an insurance contract liability requires payment depending wholly or partly on the performance of specified assets and liabilities of the insurer, the measurement of that liability should include all such payments that result from that contract, whether paid to current or future policyholders. • Provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the discount rate shall reflect that dependence. That discount rate shall reflect only the characteristics of the insurance contract liability (consistent with the	• ~~Clarification how previous decisions apply to contracts with non-guaranteed features that are not performance linked is included in AP 10A for this meeting.~~ • Whether proposed

	Topic	Tentative decisions	Open points
		objective for the discount rate used to measure non-participating insurance contracts). • Measure the performance-linked participation feature in a way that mirrors how the underlying items are measured in the US GAAP/IFRS financial statements. That could be achieved by two methods, which both lead to the same measurement: o eliminating from the expected present value of the fulfilment cash flows (including the risk adjustment for the IASB)] changes in value not reflected in the measurement of the underlying items; or o adjusting the insurer's current liability (that is, the contractual obligation incurred to date) to eliminate accounting mismatches that reflect timing differences (between the current liability and the measurement of the underlying items in the US GAAP/IFRS statement of financial position) that are expected to reverse within the boundary of the insurance contract. • An insurer should present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (ie in profit or loss, or in other comprehensive income). • For contracts with participating features where the mirroring decision applies, insurers would present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the directly linked underlying items. • **[FASB only:]** For contracts to which the mirroring decisions do not apply and where the contractual obligation to the policyholder is directly linked to the fair value of the underlying items, changes in the insurance liability should be presented in profit or loss • If options and guarantees embedded in insurance contracts are not separately accounted for as derivatives using the financial instrument requirements, they should be measured within the overall insurance contract obligation, using a current, market-consistent, expected value approach. • ***[IASB only]*****:** The insurer may recognise and measure treasury shares and owner –	measurement creates a need for any specific disclosures. This topic is discussed in AP3C for the IASB's November meeting. Agenda paper 92C for the FASB's meeting on November 14 discusses the accounting for participation features of mutual insurance companies.

	Topic	Tentative decisions	Open points
		occupied property at fair value through profit or loss.	
11.	Premium allocation approach	***[FASB only]:*** (a) Insurers should apply the building block approach rather than the premium allocation approach if, at the contract inception date, either of the following conditions is met: (i) it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract; or, (ii) significant judgement is required to allocate the premium to the insurer's obligation to each reporting period. This may be the case if, for example, significant uncertainty exists about: – the premium that would reflect the exposure and risk that the insurer has for each reporting period; or – the length of the coverage period. (b)The premium allocation approach should be required for contracts that qualify for that approach. (c)In addition, a contract should fall within the scope of the premium allocation approach without further evaluation if the coverage period is one year or less. (d)The **reinsurer** should evaluate whether to account for the reinsurance contract under the building block approach or premium allocation approach in the same manner in which an insurer should evaluate a direct insurance contract. In another words, insurers should apply the BBA rather than the PAA if, at the contract inception date, either of the following conditions is met: (i) it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of the net cash flows required to fulfil the contract; or (ii) significant judgement is required to allocate the premium to the insurer's obligation to each reporting period.	~~Discounting and interest accretion follow up issues for premium allocation approach are discussed in agenda paper 2D/90D for this meeting.~~

	Topic	Tentative decisions	Open points
		(e) The **cedant** should account for a reinsurance contract using the same approach (building block approach or premium allocation approach) that the cedant uses to account for the underlying direct insurance contracts. Reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium allocation approach should be separated based on the underlying contract measurement model, with each component being accounted for using the same approach used to account for the underlying direct insurance contracts. ***[IASB only]:*** (a) Permit, rather than require, insurers (including reinsurers) to apply the premium allocation approach for the measurement of an insurance contract liability or reinsurance asset if that approach would produce measurements that are a reasonable approximation to those that would be produced by the building block approach. (b) State that the premium allocation approach is deemed to produce measurements that are a reasonable approximation to those that would be produced by the building block approach if the coverage period is one year or less. (c) Provide application guidance that this there would not be a reasonable approximation between the approaches if: (i) it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract; or, (ii) significant judgement is required to allocate the premium to the insurer's obligation to each reporting period. This may be the case if, for example, significant uncertainty exists about: – the premium that would reflect the exposure and risk that the insurer has for each reporting period; or	

	Topic	Tentative decisions	Open points
		– the length of the coverage period. ***[For both the IASB and the FASB]:*** (a) In the premium allocation approach, the insurer measures the liability for remaining coverage using the premium receivable at inception. (b) Acquisition costs should include directly attributable costs (for FASB limited to successful efforts only), consistently with the building block approach. The insurer is permitted to recognise all acquisition costs as an expense if the coverage period is one year or less. (c) The insurer shall reduce the measurement of the liability for remaining coverage over the coverage period as follows: ▪ On the basis of time, but ▪ On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. (d) For contracts that have a significant financing component (defined in the same way as in the revenue recognition proposals), the liability for remaining coverage should reflect time value of money (by discounting and interest accretion)<u>, using the discount rate at the inception of the contract</u>. However insurers need not discount or accrue interest on the liability for remaining coverage if the period between the premium payment and satisfaction of the obligation to provide insurance coverage is expected to be one year or less. (e) For the IASB the liability for incurred claims is measured using the risk-adjusted expected present value of fulfilment cash flows. For the FASB, if an insurer applies the premium allocation approach to measure the liability for remaining coverage, it shall measure the liability for incurred claims using the expected present value of cash flows, without adding a margin. (f) Practical expedient: if an insurer applies the premium allocation approach to measure the liability for remaining coverage, it need not discount liabilities for incurred claims	

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		which are expected to be paid within 12 months. An insurer that elects to apply this practical expedient should use an undiscounted basis when identifying and measuring onerous contracts. (g) When applying the premium allocation approach, an insurer shall test whether a contract is onerous if facts and circumstances indicate that the contract might be onerous.	
12.	Reinsurance	(a) ***[IASB only]:*** The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance. (b) If the expected present value of the fulfilment cash flows (including the risk adjustment for the IASB) for the reinsurance contract is: (i) Less than zero and the coverage provided by the reinsurance contract is for future events, the cedant should include that amount in the measurement of the reinsurance recoverable, representing a prepaid reinsurance premium and should recognise the cost over the coverage period of the underlying insurance contracts. (ii) Less than zero and the coverage provided by the reinsurance contract is for past events, the cedant should recognise the loss immediately. (iii) Greater than zero, the cedant should recognise a reinsurance residual margin ***[IASB]*** / single margin ***[FASB]***. (iv) For retroactive reinsurance contracts, the residual or single margin included in the cedant's reinsurance recoverable and the reinsurer's insurance contract liability should be amortized over the remaining settlement period in the same manner as the release of the single/residual margin, ie in line with the pattern of services (for the IASB) or release from risk (for the FASB). (c) The cedant should estimate the expected present value of the fulfillment cash flow for the reinsurance contract, including the ceded premium and without reference to the residual/composite margin on the underlying contracts, in the same manner as the	How the proposed model for impairment of financial assets applies to the proposed accounting for reinsurance assets. Agenda paper 92A for the FASB meeting on November 14 discusses the accounting for ceding commissions.

	Topic	Tentative decisions	Open points
		corresponding part of the expected present value of the fulfillment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contracts on initial recognition of the reinsurance contract. (d) An insurer should treat cash flows resulting from contractual features affecting the amount of premiums and ceding commissions that are contingent on claims or benefits experience (often referred to as 'loss sensitive features') as part of the claims and benefits cash flows (rather than as part of the premiums) if they are not accounted for as investment components. An insurer should treat any premium adjustments that are not loss-sensitive in the same way as other changes in estimates of premiums arising from the contract. Any features that provide cedants with a unilateral right (but not an obligation) to pay a premium and reinstate a reinsurance contract should not be considered to be loss sensitive features for the purpose of applying this guidance. (e) When considering non-performance by the reinsurer: (i) The cedant shall apply the impairment model for financial instruments when determining the recoverability of the reinsurance asset. (ii) The assessment of risk of non-performance by the reinsurer should consider all facts and circumstances, including collateral. (iii) Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that current information and events suggest the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract. (f) ***[IASB only]:*** Both the cedant and reinsurer should evaluate whether to account for the reinsurance contract using the building block approach (BBA) or the premium allocation approach (PAA) in the same manner in which an insurer should evaluate a direct insurance contract. In other words, the PAA would be permitted if it would produce measurements that are a reasonable proxy to those that are produced by the BBA.	

	Topic	Tentative decisions	Open points
		(g) ***[FASB only]:*** The **reinsurer** should evaluate whether to account for the reinsurance contract under the building block approach or premium allocation approach in the same manner in which an insurer should evaluate a direct insurance contract. In another words, insurers should apply the BBA rather than the PAA if, at the contract inception date, either of the following conditions is met: (iii) it is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of the net cash flows required to fulfil the contract; or (iv) significant judgement is required to allocate the premium to the insurer's obligation to each reporting period. (h) ***[FASB only]:*** The **cedant** should account for a reinsurance contract using the same approach (building block approach or premium allocation approach) that the cedant uses to account for the underlying direct insurance contracts. Reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium allocation approach, should be separated based on the underlying contract measurement model, with each component being accounted for using the same approach used to account for the underlying direct insurance contracts.	

	Topic	Tentative decisions	Open points
13.	Onerous contracts	• A portfolio of insurance contracts is onerous if the expected present value of the future cash outflows from that portfolio [plus, for the IASB, the risk adjustment] exceeds: o the expected present value of the future cash inflows from that portfolio (for the pre-coverage period). o the carrying amount of the liability for the remaining coverage (for the premium allocation approach). • ***[IASB only]:*** the risk adjustment should be considered when identifying and measuring onerous contracts. • Onerous contracts should be measured: o If identified in the pre-coverage period, on a basis that is consistent with the measurement of the liability recognised at the start of the coverage period. o If identified under the premium allocation approach, on a basis that is consistent with the measurement of the liability for claims incurred. o An insurer that elects not to discount the liability for incurred claims that are expected to be paid within 12 months should use an undiscounted basis when identifying and measuring onerous contracts. o The measurement of the liability for onerous contracts should be updated at the end of each reporting period.	
14.	Contract modifications	• An insurer should derecognise an existing contract and recognise a new contract (under the applicable guidance for the new contract) if it amends the contract in a way that would have resulted in a different assessment of either of the following items had the amended terms been in place at the inception of the contract: o whether the contract is within the scope of the insurance contract standard; or o whether to use the premium allocation approach or the building block approach to account for the insurance contract. • ***[IASB only]:*** An insurer shall derecognise an existing contract and recognise a new contract if it amends the contract in a way that would have resulted in the contract	

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		being included in a different portfolio than the one in which it was included in at initial recognition. [The FASB plans to consider which additional circumstances will result in derecognition and whether there needs to be application guidance.] • When an insurer makes a substantial modification to an insurance contract, the gain or loss on extinguishment of the original contract should be determined by measuring the existing insurance contract using the current entity-specific price that the insurer would hypothetically charge the policyholder for a contract equivalent to the newly recognized insurance contract. • Insurers should account for non-substantial modifications as follows: o If the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required it to provide, the insurer shall derecognise that portion of its obligation (including any related portion of the residual/single margin). o If the modification entitles the policyholder to further benefits, the insurer shall treat the modification as if the amendment was a new standalone contract (ie, the margin is determined in the same way as for a new standalone contract with no effect on the measurement of the original contract).	
	Definitions, scope and unbundling		
15.	Definitions	• Definition of an insurance contract - Confirm proposed definition in the ED and DP, together with the guidance that: o an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant. o a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss, with loss defined as an excess of the present value of net cash outflows over the present value of the premiums. • If a reinsurance contract does not transfer significant insurance risk because the	

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		reinsurer is not exposed to a loss, the reinsurance contract is nevertheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts is assumed by the reinsurer. • An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent should be considered a single contract for the purpose of determining risk transfer. • ***[IASB only]*:** A portfolio of insurance contracts should be defined as contracts that are: o subject to similar risks and priced similarly relative to the risk taken on; and o managed together as a single pool. • ***[FASB only]*:** A portfolio of insurance contracts should be defined as contracts that are: o subject to similar risks and priced similarly relative to the risk taken on; and o have similar duration and similar expected patterns of release of the single margin.	
16.	Scope	• Exclude from the scope of the insurance contracts standard fixed–fee service contracts that provide service as their primary purpose and that meet all of the following criteria: o The contracts are not priced based on an assessment of the risk associated with an individual customer, o The contracts compensate customers by providing a service, rather than cash payment, and, o The type of risk transferred by the contracts are primarily related to the utilization (or frequency) of services relative to the overall risk transferred • ***[IASB only]*:** Financial guarantee contracts (as defined in IFRSs) would not be in the scope of the insurance contracts standard as proposed in the ED. Instead an issuer of a financial guarantee contract (as defined in IFRSs): o may account for the contract as an insurance contract if the issuer had previously	• ***[FASB only]:*** which financial guarantee arrangements, if any, should be within the scope of the insurance contracts standard. • ~~If there are any adaptations needed for the participating features measurement to apply to investment contracts with DPF.~~

	Topic	Tentative decisions	Open points
		asserted that it regards such contracts as insurance contracts; and o should apply the financial instruments standards to these contracts in all other cases. • Confirmed all the other scope exceptions proposed in the ED • **[IASB only]**: Financial instruments with discretionary participating features (DPF) should be in the scope of the insurance contracts standard. • ***[FASB only]***: Title insurance should be in the scope of the insurance contracts standard. • ***[FASB only]***: Exclude from the scope of the proposed insurance contract standard charitable gift annuities within the scope of *FASB Accounting Standards Codification® Topic 958 Not-for-Profit Entities,* which possess a donation element and are issued by not-for-profit entities.	~~This is discussed in AP10A for this meeting.~~
17.	Unbundling	**What to unbundle** (a) An insurer should separate **embedded derivatives** that are not closely related to the insurance contract and account for them using IFRS 9 *Financial Instruments*. (b) An insurer shall identify whether any promises to provide **goods or services** in an insurance contract would be performance obligations as defined in the Exposure Draft *Revenue from Contracts with Customers*. If a performance obligation to provide goods or services is distinct, an insurer shall apply the applicable IFRSs or US GAAP in accounting for that performance obligation. (i) A performance obligation is a promise in a contract with a policyholder to transfer a good or service to the policyholder. Performance obligations include promises that are implied by an insurer's customary business practices, published policies, or specific statements if those promises create a valid expectation of the policyholder that the insurer will transfer a good or service. Performance obligations do not include activities that an insurer must undertake to fulfil a contract unless the insurer transfers a good or service to a policyholder as those	

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	activities occur. For example, an insurer may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder. Hence, the promise to perform those setup activities is not a performance obligation. (ii) Except as specified in the following paragraph, a good or service is distinct if either of the following criteria is met: (1) the insurer regularly sells the good or service separately. (2) 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. Readily available resources are goods or services that are sold separately (by the insurer or another entity), or resources that the policyholder already has obtained (from the insurer or from other transactions or events). (iii) Notwithstanding the requirements in the previous paragraph, a good or service in an insurance contract is not distinct and, therefore, the insurer shall account for the good or service together with the insurance component under the insurance contracts standard if both of the following criteria are met: (1) The good or service is highly interrelated with the insurance component and transferring the good or service to the policyholder requires the insurer also to provide a significant service of integrating the good or service into the combined insurance contract the insurer has entered into with the policyholder. (2) The good or service is significantly modified or customized in order to fulfil the contract. (c) An investment component in an insurance contract is an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs. (d) an insurer should unbundle a **distinct investment component** and apply the applicable	

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	IFRSs or U.S. GAAP in accounting for the investment component. An investment component is distinct if the investment component and the insurance component are not highly interrelated. Indicators that an investment component is highly interrelated with an insurance component include: (i) A lack of possibility for one of the components to lapse or mature without the other component also lapsing or maturing, (ii) If the products are not sold in the same market or jurisdiction, or (iii) If the value of the insurance component depends on the value of the investment component or if the value of the investment component depends on the value of the insurance component. An insurer shall account for investment components that are not distinct from the insurance contract together with the insurance component under the insurance contracts standard. (e) insurers should be prohibited from applying revenue recognition or financial instrument standards to components of an insurance contract when unbundling is not required. **How to unbundle** (f) In applying the general decisions on unbundling and disaggregation, policy loans should be considered in determining the amount of the investment component to which they relate. (g) An insurer should account for contract modifications (eg riders) that are part of the insurance contract at inception as part of the contractual terms of the contract. Thus the general decisions on unbundling and disaggregation should apply to riders. (h) An insurer should attribute cash flows to an investment component and to an embedded derivative on a stand-alone basis. This means that an insurer would measure an investment component or embedded derivative as if it had issued that item as a separate contract. The insurer would thus not include the effect of any cross-subsidies or	

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		discounts/ supplements in the investment component. (i) after excluding the cash flows related to unbundled investment components and embedded derivatives: (i) the amount of consideration and discounts/ supplements should be attributed to the insurance component and/ or service component in accordance with proposals in paragraphs 70-80 of the exposure draft *Revenue from Contracts with Customers*. (ii) cash outflows (including expenses and acquisition costs) that relate directly to one component should be allocated to those components on a rational and consistent basis, reflecting the costs that the insurer would expect to incur if it issued that component as a separate contract. Once cash outflows are attributed to components, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component. (j) ***[FASB only]***: A title insurance contract should be unbundled into a service component (a title search service component accounted for using the revenue recognition standard) and an insurance component (indemnification component that covers title defects that would be accounted for using the insurance contracts standard). The application guidance would include an example to illustrate this requirement.	
	Presentation and disclosures		
18.	Premiums claims and expense in statement of comprehensive income	• An insurer should present premiums, claims, benefits, and the gross underwriting margin in the statement of comprehensive income. • <u>The premiums and claims presented in an insurer's statement of comprehensive income should be determined by applying an earned premium presentation, whereby premiums are allocated to periods in proportion to the value of coverage (and any other services) that the insurer has provided in the period, and that claims should be presented when incurred.</u> • <u>**[FASB only]** The FASB also asked the FASB staff when drafting to consider the</u>	• ~~How to define and present volume information in the statement of comprehensive income:~~ • ~~General presentation approach is discussed in AP2A/90A for this~~

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		inclusion of application guidance about other approaches that may meet the earned premium principle, noting that the description of the approach within the Agenda Papers was too prescriptive. • The premium allocated to cover non-claims fulfilment costs (which is equal to the originally expected non-claims fulfilment costs included in the measure of the liability) should be included in earned premium in the periods in which the costs are expected to be released from the liability for remaining coverage, ie when it is expected that they will be either incurred or added to the liability for incurred claims. • The amounts presented as expenses should be the actual costs incurred or be added to the liability for incurred claims in the period. • ***[IASB only]*:** Insurers should exclude from the aggregate premium presented in the statement of comprehensive income the present value of the amounts the insurer is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs, determined consistently with measurement of the overall insurance_contract liability. • ***[FASB only]:*** An insurer should allocate an amount of consideration to the insurance component for each period, resulting in premium recognised in the statement of comprehensive income, equal to the (implicit or explicit) cost of insurance and other fees charged that period to the policyholder account balances. That amount may be calculated by deducting from total consideration the amount, if any, allocated that period to an investment component (and thus excluded from the premium presented in the statement of comprehensive income). The amount of consideration allocated to the investment component for each period may be determinable as follows: +/- increase (decrease) in the amount of the cash surrender value (or other account balance the policyholder is entitled to through lapse, etc.) for the period + the amount of surrenders + the cash surrender value included in any death benefits paid	~~meeting.~~ • ~~Presentation of acquisition costs is discussed in AP2C/90C presentation of other non-claims fulfilment costs is discussed in AP2B/90B for this meeting.~~ • ~~Whether to present as a single line item in the statement of comprehensive income the effects of amortising acquisition costs and the single/residual margin (or liability for remaining coverage in the premium allocation approach is discussed in AP2A/90A.~~ • Agenda paper 3B for the IASB's November meeting discusses the presentation in the financial statements. ~~Whether the~~

	Topic	Tentative decisions	Open points
		- interest credited = consideration allocated to the investment component. The FASB may reconsider this decision at a later date in connection with the decision yet to be made regarding the premium recognition pattern.	~~face of the primary statements should present information about contracts accounted for using the premium allocation approach separately from those accounted for using the building block approach.~~ • ~~Presentation of reinsurance assets, policyholder participation and short duration contracts~~ • <u>Agenda paper 3C for the IASB's November meeting discusses disclosures needed to support the earned premium presentation approach.</u>
19.	Other items in the statement of comprehensive income	• Reinsurers and cedants should present any gains or losses on commutations as an adjustment to claims or benefits and should not gross up the premiums, claims, or benefits in recognising the transaction on the statement of comprehensive income.	<u>Agenda paper 3B for the IASB's November meeting discusses the presentation in the statement of comprehensive income.</u>

	Topic	Tentative decisions	Open points
20.	Other comprehensive income	• When an insurance contract requires payment depending wholly or partly on the performance of specified assets and liabilities of the insurer it should present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (ie in profit or loss, or in other comprehensive income). • An insurer shall be required to present in OCI changes in the insurance liability arising from changes in the discount rate and to present in profit or loss interest expense using the discount rate locked in at inception of the insurance contract. • When the liability for incurred claims is discounted, an insurer should use the rate at the inception of the contract to determine the amount of the claims and interest expense in profit or loss. That rate is subsequently locked in. • For contracts with participating features where the mirroring decision applies, insurers would present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the directly linked underlying items.	Agenda paper 2A for the joint November meeting discusses whether to reset the locked-in discount rate used to determine interest expense in profit or loss in some circumstances.
21.	Statement of financial position	• An insurer should disaggregate the following components, either in the statement of financial position or in the notes, in a way that reconciles to the amounts included in the statement of financial position: (a) Expected future cash flows (b) Risk adjustment (for the IASB), (c) Residual margin (for the IASB), (d) The single margin, where relevant (for the FASB), and (e) The effect of discounting. • For those contracts measured using the premium allocation approach, the statement of financial position should present the liability for remaining coverage separately from the liability for incurred claims.	Agenda paper 3B for the IASB's November meeting discusses the presentation in the statement of financial position.

	Topic	Tentative decisions	Open points
		• For those contracts measured using the building block approach, the statement of financial position should present any unconditional right to any premiums or other consideration as a receivable separately from the insurance contract asset or liability. The insurer should account for that receivable in accordance with existing guidance for receivables. The remaining insurance contracts rights and obligations should be presented on a net basis in the statement of financial position. • For those contracts measured using the premium allocation approach, the statement of financial position should present all insurance contract rights and obligations on a gross basis. • Liabilities (or assets) for insurance contracts should be presented separately for those measured using the building block approach and those measured using the premium allocation approach. • The statement of financial position should not aggregate portfolios that are in an asset position with portfolios that are in a liability position. • <u>[**FASB only:**] disaggregate in the statement of financial position the insurance contracts liability into the expected cash flows to fulfil the insurance obligation and the margin. Acquisition costs should be reported as part of the margin (ie the margin includes the acquisition costs expected to be paid and is reduced when those acquisition costs are paid).</u>	
22.	Disclosures	Confirm the disclosures proposed in paragraphs 90-97 of the IASB's exposure draft *Insurance contracts* (ED), with changes as follows: (a) to delete the requirement that an insurer shall not aggregate information relating to different reportable segments (ie paragraph 83 of the ED) to avoid a conflict with the principle for the aggregation level of disclosures. Thus the level of aggregation could vary for different types of qualitative and quantitative disclosures. However, the standard would add to the examples listed in paragraph 84 of the ED by stating that one appropriate aggregation level might be reportable segments.	• FASB: The FASB plans to perform further outreach before voting on disclosures to be included in an exposure draft. • <u>IASB: Agenda paper 3D</u>

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		(b) to require the insurer to disclose separately the effect of each change in inputs and methods, together with an explanation of the reason for the change, including the type of the contracts affected. (c) for contracts in which the cash flows do not depend on the performance of specified assets (ie non-participating contracts), to require disclosure of the yield curve (or range of yield curves) used. (d) To require disclosure of-the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income. (e) ***[IASB only]:*** to require the maturity analysis of net cash outflows resulting from recognised insurance liabilities proposed in paragraph 95(a) of the ED to be based on expected maturities and remove the option to base maturity analysis on remaining contractual maturities. Furthermore, within the context of time bands, to require the insurer to disclose, at a minimum, the expected maturities on an annual basis for the first five years and in aggregate for maturities beyond five years. *[In place of this disclosure, the FASB would rely on its tentative decisions relating to risk disclosures for financial institutions reached in its project on financial instruments at the FASB board meeting held on 7 September 2011. Those disclosures would apply to insurance entities.]* (f) ***[IASB only]:*** to delete the proposed requirement in paragraph 90(d) of the ED to disclose a measurement uncertainty analysis and to consider (in due course) whether to develop disclosure about measurement uncertainty part of a possible follow up to IFRS 13 *Fair Value Measurement*. (The FASB tentatively decided to retain this disclosure.) (g) to require disclosure of gains or losses arising on contract modifications, commutation or derecognition. (h) to require a reconciliation between opening and closing carrying amounts.	<u>for the IASB's November meeting discusses disclosure requirements for interim financial reports.</u>

	Topic	Tentative decisions	Open points
		(i) to require a reconciliation of the carrying amounts of onerous contract liabilities recognised in the pre-coverage period. (j) to require disclosure of a reconciliation between the opening aggregate carrying amount and closing aggregate carrying amount of insurance contract liabilities and insurance contract assets, showing separately: (i) the expected present value of fulfilment cash flows (ii) risk adjustment (iii) residual margin. (k) to require disclosure of amounts payable on demand in a way that highlights the relationship between such amounts and the carrying amount of the related contracts. (l) to delete the specific disclosure proposed in paragraph 89 of the ED about contracts for which uncertainty about the amount and timing of claims payments is not typically fully resolved within one year.	
	Other		
23.	Business combination issues		• <u>Agenda paper 92B for the FASB's meeting on November 14 discusses issues relating to business combinations and portfolio transfers.</u>
24.	Transition	**Measurement** When an insurer first applies the new insurance contracts standard, the insurer shall: 1. At the beginning of the earliest period presented: a. Measure the present value of the fulfilment cash flows using current estimates at the date of transition (i.e., as of the earliest period presented). b. Account for the acquisition costs in accordance with the board's existing tentative decisions for acquisition costs and derecognise any existing balances of deferred	• ~~Redesignation and reclassification of financial assets is discussed in AP 10C for this meeting~~ • ~~Determine effective date, comparative~~

	Topic	Tentative decisions	Open points
		acquisition costs. 2. Determine the single or residual margin at the beginning of the earliest period presented, as follows: a. Determine the margin through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so. b. If it is impracticable to determine the cumulative effect of applying that change in accounting principle retrospectively to all prior periods, the insurer is required to apply the new policy to all contracts issued after the start of the earliest period for which retrospective application is practicable (i.e., apply retrospectively as far back as is practicable). c. For contracts issued in earlier periods for which retrospective application would normally be considered impracticable because it would require significant estimates that are not based solely on objective information, an insurer shall estimate what the margin would have been had the insurer been able to apply the new standard retrospectively. In such cases, an insurer need not undertake exhaustive efforts to obtain objective information but shall take into account all objective information that is reasonably available. d. If it is impracticable to apply the new accounting policies retrospectively for other reasons, an insurer shall apply the general requirements of ASC Topic 250-10/ IAS 8 that are relevant to situations in which there are limitations on retrospective application (ie measure the margin by reference to the carrying value before transition). 3. **[IASB only:]**Determine the residual margin on transition, assuming that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition The boards asked the staff to consider developing a constraint or set of constraints on the	~~financial statements and early application is discussed in agenda paper 10E~~ • ~~Ancillary issues are discussed in agenda paper 10D~~ • Agenda paper 3C for the IASB's November meeting discusses the disclosure requirements in IAS 8.

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	estimated amount of the single or residual margin. In addition, the FASB board asked the staff to explore a practical expedient that may allow insurers to determine the margin based on the definition of portfolios during the retrospective period. **Determining the discount rate** For those periods for which it would be impracticable to determine the discount rate that would reflect the characteristics of the liability, insurers shall, determine the discount rate as follows: (a) Calculate the discount rate in accordance with the standard for a minimum of three years and. If possible, determine an observable rate that approximates the calculated rates. If there is not an observable rate that approximates the calculated rate then determine the spread between the calculated rate and a observable rate. (b) Use the same observable reference point to determine the rate (plus or minus the spread determined in (a) if applicable) to be applied at the contract inception for contracts that were issued in the retrospective period. (c) Apply the yield curve corresponding to that rate to the expected cash flows for contracts recognized in the retrospective period to determine the single or residual margin at contract inception. (d) Use the rate from the reference yield curve reflecting the duration of the liability for recognizing interest expense on the liability. (e) Recognise in other comprehensive income the cumulative effect of the difference between that rate and the discount rate determined at the transition date. **Transition reliefs** <u>**[IASB only:]** An insurer shall follow the reclassification guidance in IFRS 9 Financial Instruments except that an insurer should be:</u> • <u>permitted to designate eligible financial assets under the fair value option where new</u>	

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	<u>accounting mismatches are created by the application of the proposed new Insurance Contracts Standard;</u> • <u>required to revoke previous designations under the fair value option where the accounting mismatch no longer exists because of the application of the proposed new Insurance Contracts Standard;</u> • <u>following earlier application of IFRS 9, permitted to newly elect to use other comprehensive income for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election if applicable.</u> <u>No explicit guidance on redesignation of property, plant and equipment and investment property on transition.</u> <u>**[FASB only:]**</u> <u>On initial adoption of the insurance contracts standard, the insurer will be permitted to designate and classify its financial assets that are designated to an entities' insurance business either by:</u> a. <u>legal entity or</u> b. <u>internal designation and relating to funding of insurance contracts that are newly determined to be insurance</u> <u>as if it had adopted on that date the relevant classification and measurement guidance for financial instruments in effect (ASC 320 and related fair value options or the proposed FASB financial instruments standard), the impact from which should be reported as a change in accounting principle.</u> **Transition disclosures** The boards tentatively decided that insurers shall make the disclosures required by ASC Topic 250-10/IAS 8. In addition, insurers shall make the following more specific	

	Topic	Tentative decisions	Open points
		disclosures: (a) If full retrospective application is impracticable, the earliest practicable date to which the insurer applied the guidance retrospectively. (b) The method used to estimate the expected remaining residual or single margin for insurance contracts issued before that earliest practicable date including the extent to which the insurer has used information that is objective and separately, the extent to which the insurer has used information that is not objective, in determining the margin. (c) The method and assumptions used in determining the initial discount rate during the retrospective period. An insurer need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it first applies the new guidance. Furthermore, if it is impracticable when an insurer first applies the guidance to prepare information about the claims development that occurred before the beginning of the earliest period for which the insurer presents full comparable information, it shall disclose that fact. (This decision confirms the proposal in the IASB's ED.) The proposed transition requirements for insurers that already apply IFRS also apply to first-time adopters of IFRS.	
25.	Effective date, comparative information and early adoption	**IASB only:** The IASB stated its intention to allow approximately three years between the date of publication of the final Insurance Contracts Standard and the mandatory effective date. In addition: the IASB tentatively decided: • to permit entities to apply the final Insurance Contracts Standard before the mandatory effective date; and	

	Topic	Tentative decisions	Open points
		• <u>to require entities to restate comparative financial statements on first application of the final Insurance Contracts Standard.</u>	