STAFF PAPER

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REG IASB Meeting

Project	Insurance Contracts		
Paper topic	Sweep issues		

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Introduction

1. This paper considers the sweep issues (ie narrow issues) that were raised by respondents to the Exposure Draft (ED) or are unintended consequences identified as a result of the IASB's tentative decisions. The staff proposes to discuss these issues with the IASB on an exceptions basis, ie the staff will ask only a general question as to whether the IASB agrees with the staff's proposals. We would discuss an issue only if requested to do so by an IASB member. The staff asks for advance notification from IASB members if they intend to discuss any issues to assist in meetings planning.

Question for the IASB
1. Do you agree with all of the staff recommendations (summarised in paragraph 2)?

Summary of staff recommendations

2. The following table summarises the staff recommendations on the issues discussed in this paper:

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

Issue	Staff recommendation	Paragraph numbers
Scope—policyholder accounting	Do not address policyholder accounting (except for cedants) in this project.	3-5
Grandfathering of the definition of an insurance contract	Do not create explicit guidance.	6-11
Takaful	Do not create explicit guidance.	12-22
Recognition point for deferred annuity contracts	Revise the recognition point to clarify that the recognition point for deferred annuities is the earlier of the start of the coverage period or the date on which the first premium becomes due. In the absence of a contractual due date, the premium is deemed to be due when received.	23-34
Income taxes included in fulfilment cash flows	Clarify that cash flows relating to tax payments should be evaluated and treated like any other cash flows.	35-42
Discounting of deferred taxes	Do not address discounting of deferred taxes in this project.	43-45
Tacit renewals	Do not create explicit guidance.	46-47
Cash bonus	Do not create explicit guidance.	48-52
Reinsurance contracts held by cedant— unfavourable changes that adjust the positive residual margin	Do not impose a limit on unfavourable adjustments against the positive residual margin.	53- 59
Treatment of ceding commission in cedant's financial statement	Confirm the ED proposal that an insurer should treat ceding commissions as a reduction of premiums ceded to reinsurer.	60-64
Alignment of the allocation pattern for the premium in the premium allocation approach with the residual margin in the building block approach	Align the requirements to reduce the liability for remaining coverage to the requirements for releasing the residual margin in the building block approach.	65-70
Disclosure of maturity analysis for contracts accounted for using the premium allocation approach	The insurer shall be relieved from providing disclosure about maturity analysis of cash flows for the liability for remaining coverage for contracts accounted for using the premium allocation approach.	71-73
Acquiring a portfolio as part of a business combination or portfolio transfer	Confirm ED proposal that different requirements should apply to business combinations and portfolio transfers.	74-78

Issue	Staff recommendation	Paragraph numbers
Allocation period of residual margin in a business combination or portfolio transfer	Do not create explicit guidance.	79-82
Transition—business combination	On transition to the new standard, an insurer shall assume that all in force contracts had been originated by the entity.	83-89
Implementation guidance in IFRS 4	Do not carry forward the implementation guidance that currently accompanies IFRS 4 to the new standard.	90-92

Scope—Policyholder accounting

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3. The ED proposes to carry forward the scope of IFRS 4, ie that the standard would apply to insurance contracts issued by an entity and reinsurance contracts held by a cedant. The ED did not deal with the accounting by policyholders other than cedants (BC 188).

4. We received limited feedback from respondents who requested that the future Standard should also deal with policyholder accounting. However, as evidenced by the limited number of responses, this does not appear to be a sufficiently widespread issue to justify widening the scope of the project at this time.

Staff recommendation

5. The staff recommends that the IASB should not address policyholder accounting (except for cedants) as part of the project.

Grandfathering of the definition of an insurance contract

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6. IFRS 4 defined an insurance contract as "A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder".

7. The ED used the existing definition in IFRS 4, but proposed two additions in the application guidance supporting that definition to reflect the boards' understanding of current practice and existing US GAAP. Those additions:

    (a) require that an insurer must consider the time value of money in assessing whether the additional benefits payable in any scenario are significant; and

    (b) state that a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which an insurer can suffer a loss. Loss is defined here as an excess of the present value of net cash outflows over the present value of the premiums.

8. Most respondents to the IASB's ED did not comment on the definition of an insurance contract. In the redeliberations since the ED, the IASB noted comments that the application of IFRS 4 had been consistent with the proposed changes and that no significant objections were made to the proposals in the ED. We therefore confirmed the definition of an insurance contract and the supporting application guidance. However, to address one of the issues raised, we added the clarification that a reinsurance contract is deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contract is assumed by the reinsurer, even if the reinsurer is not exposed to a loss from the contract.

9. Some preparers are concerned that even minor changes to the guidance supporting the definition in IFRS 4 would require them to re-assess all their existing contracts to ensure that they all met the new definition. Many insurers found the exercise of assessing the significance of risk transfer in their contracts to be onerous on first

application of IFRS 4. Because there was no intention to change existing practice, they propose that the IASB should add an explicit statement that insurers do not need to do this exercise again.

10. However, the staff questions whether explicit guidance is necessary. The definition of an insurance contract as proposed is the same as that in IFRS 4. From the comment letters, it appears that most constituents agree with the IASB's assessment that the proposed changes to the guidance supporting the definition would not cause a change in current practice as compared to existing IFRS 4. Consequently, in most cases, there should be no need to reassess whether contracts that met the definition of insurance contracts in IFRS 4 would meet the definition in the new Standard.

Staff recommendation

11. The staff recommends that explicit guidance is not required.

Takaful

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Background

12. *Takaful* arrangements are designed to offer participants protection that is comparable with conventional insurance whilst adhering to Shariah principles. The Fiqh Academy of the Organisation of Islamic Cooperation views a conventional insurance contract as a sale of protection by the insurer in return for a premium as consideration from the policyholder. In 1985, the Academy opined (pronounced) that such a sale contract is *haram* (forbidden) because it contains prohibited elements[1]. Among these are:

    (a) *gharar* (uncertainty) as to the subject of sale;

[1] Islamic Development Bank. "Concerning Insurance and Reinsurance". *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000*. Jeddah. 2000. Pgs 13-14.

(b) *riba* (‘excess’ or usury) on either the difference between the value of the item sold (ie the potential claims) and its consideration (ie the premium), or from the returns on interest-bearing investment; and

(c) *maisir* (gambling) as there may be an expectation of getting a large amount by paying a comparatively much smaller amount.

13. Although Islam does not have a concept of clergy, the opinions of respected scholars such as the Fiqh Academy are influential and often adhered to, leading to the development of an alternative to insurance. Takaful is established on the concepts of *tabarru’* (donation) and *ta’awun* (mutual cooperation). The main features are as follows:

(a) Instead of purchasing insurance from an insurer, takaful participants pay contributions to a fund to mutually indemnify each other. In the event that a member suffers a loss, the other participants agree to forgo part or all of their contributions to the aggrieved member.

(a) Takaful funds are usually initiated by a takaful operator who would solicit participants to a fund and manage the participants’ fund. The takaful operator usually determines whether to accept a participant and the amount of contributions the participant pays to the fund.

(b) The takaful operator may receive a fee and/or a share of the fund’s profits and surpluses, depending on how the arrangement between the operator and the participants is structured.

(c) Takaful contracts may contain features that allow participants to benefit from surpluses – such as from higher than expected investment performance or lower than expected claims. These features typically take the form of either a retroactive contribution adjustment or a performance clause, and may be considered participating features.

(d) The participants nominally bear the risk of any shortfalls of the fund, but the takaful operator generally provides financial assistance to cover any deficits. Financial assistance may take the form of *qard*, a non-interest-bearing loan to be repaid or recouped at face amount from future surpluses.

14. A few comment letters on the IASB's ED asked the boards to clarify:

    (a) Whether takaful arrangements would be within the scope of the insurance contracts ED; and

    (b) Questions relating to the consolidation of takaful pools.

The Malaysian Accounting Standards Board ('MASB') discussion paper on takaful arrangements

15. In December 2011, the Malaysian Accounting Standards Board ('MASB') issued a discussion paper on the accounting for takaful contracts[2]. That discussion paper considered issues that might ensue from applying IFRS to takaful transactions in Malaysia, noting that although takaful can be likened to conventional insurance, it has distinct features which warrant further discussion. In particular, the discussion paper considered:

    (a) Whether takaful meets the definition of an insurance contract.

    (b) Whether a takaful operator should prepare consolidated financial statements.

    (c) How to account for *qard*, an interest-free loan extended by a takaful operator to a participants' fund that is in deficit.

16. In considering these issues, the MASB noted that:

    "Once [the IASB's insurance contracts project is] finalised as an IFRS, and adopted as an approved accounting standard by MASB, *takaful* entities are unlikely to be exempted from the recognition and measurement requirements of the revised MFRS on insurance contracts, or from any other MFRS[3]. This is in line with MASB's policy that *Shariah* compliant transactions and events shall be accounted for in accordance with MASB approved accounting standards in the absence of a *Shariah* prohibition."

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[2] The discussion paper is available from: http://www.masb.org.my/images/stories/161211/MASB%20DP%20i-1Takaful.pdf

[3] Malaysian Financial Reporting Standards, based on IFRSs.

17. Although the discussion paper was issued for comment in Malaysia, we do not see any reason why the analysis undertaken by the MASB should not apply wherever takaful arrangements are in place.

18. The tentative conclusions in the MASB's discussion paper relating to the questions in paragraph 15 are:

    (a) A participants' fund which has accepted the transfer of risk from an individual participant to a pool of participants shall apply the [insurance contracts standard] to that contract which transfers the risk from the individual participant to the pool of participants.

    (b) Where a takaful operator has an obligation or agreement to extend financial assistance to a participants' fund in deficit, and repayment or recoupment of that financial assistance is related to and dependent on the underwriting results of the fund, the takaful operator may have (whether directly or indirectly) accepted significant insurance risk. A takaful operator that is deemed to have accepted significant insurance risk shall apply the [insurance contracts standard] to the transaction deemed to have transferred the risk.

    (c) Qard appears to meet the definition of a financial instrument and hence should be accounted for using financial instruments standards.

    (d) A takaful operator that has control over participants' funds within the meaning of IAS 27 / IFRS 10 is required to present consolidated financial statements for itself and the participants' funds it controls.

19. The comment period for the MASB's discussion paper ended on 16 March 2012. In January 2013, the MASB issued a feedback statement summarising the comments received on the discussion paper[4].

20. In the feedback statement, the MASB states that it has decided not to develop guidance on Takaful (or any other Islamic Financial Reporting matters) because it is concerned that it might be viewed as a local interpretation of IFRS that may not be acceptable to the IASB. The feedback statement goes on to state that:

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[4] This feedback statement is available from: http://www.masb.org.my/images/Feedback%20Statement%20for%20issuance.pdf

> Nevertheless, the MASB is seeking other acceptable avenues for getting consensus opinions to its constituents. An option being explored is for local industry regulators or the Malaysian Institute of Accountants (MIA) to issue guidance. Another is to lobby for the IASB itself to issue guidance on Islamic financial reporting matters.

Staff recommendation

21. Neither the IASB nor the staff have any expertise in the area of shariah-compliant transactions. Consequently, we do not propose to provide specific guidance for takaful arrangements in the ED.

22. However, the staff note that IASB has decided to establish a consultative group to help:

    (a) assess the relationship between IFRS and shariah-compliant transactions; and

    (b) educate the IASB in this area.

    The MASB has been asked to assist in setting up this group. The staff believe that this group may wish to consider the issues with Takaful transactions once it has been established.

Recognition point for deferred annuity contracts

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23. The following paragraphs discuss:

    (a) the background on the recognition point decision (paragraphs 24-25);

    (b) a summarised description of deferred annuities (paragraphs 26-27);

    (c) the treatment of deferred annuities during the savings phase (paragraphs 28-31); and

    (d) the staff recommendation (paragraphs 32-34).

Background

24. The ED proposed that an insurance contract asset or liability is recognised when the insurer becomes a party to the contract. In response to the views received that the costs of that proposal (ie additional administrative burdens) would outweigh the benefits (ie the information provided), the boards tentatively decided that an insurer should initially recognise an asset or liability:

    (a) when the coverage period starts; or

    (b) earlier, if the contract is onerous.

25. Since then, the staff has received questions on how these proposals would apply to deferred annuity contracts, because some think it is unclear when the coverage periods begins for those contracts.

Deferred annuities

26. A deferred annuity is an annuity in which the policyholder does not begin to receive payments until some future date. A deferred annuity has two phases: a savings phase and an income phase. During the savings phase, the annuitant places money with the insurer, which invests it on behalf of the policyholder. In the income phase, the policyholder receives payments. Sometimes the policyholder has the option to receive either a lump sum or a series of annuity payments.

27. Only deferred annuities with a guaranteed minimum annuity rate transfer insurance risk. The contract transfers mortality risk at inception because the insurer may have to pay additional benefits if the annuitant elects to take the life-contingent annuity and because the insurer is unable to reprice for the coverage of providing compensation for surviving longer than expected. The staff considered only deferred annuities that meet the definition of an insurance contract.

Treatment during the savings phase

28. Some suggest that the current treatment under US GAAP for deferred annuity contracts should be preserved. Under US GAAP, these contracts are treated as a financial instrument in the savings phase and only as insurance on annuitisation.

This treatment would be preserved if the recognition point for these contracts as insurance contracts were to begin only during the annuitisation phase. Arguably this would be the case under the boards' tentative decisions because the insurance contract asset or liability is recognised at the start of the coverage period, and some people might argue that the coverage period starts only when the deferred annuity is in the annuitisation phase.

29. However, treating these contracts as insurance contracts only on annuitisation has been implicitly rejected by the boards. Previous agenda papers on unbundling considered whether special requirements should apply to these contracts. The boards chose not to develop specific unbundling requirements to unbundle deferred annuity contracts. Consequently, it was the boards' intention that the general requirements for unbundling should apply to these contracts. Under those requirements, the investment and insurance component remain bundled for deferred annuities, because those components are interdependent (for example, the value of the annuitisation option is dependent on the amount invested and the investment returns promised).

30. In addition, the staff thinks that applying the insurance contracts standard from the outset provides more useful information than treating the deferred annuity in the saving phase as a financial instrument. Under the financial instruments requirements, those contracts would be accounted for at amortised cost and hence, the value of the annuitisation option would not be remeasured at current value. Consequently, users would not be able to understand the risks arising from these contracts. The staff believes that this is one of the reasons that the IASB decided that deferred annuities with guaranteed annuitisation rates meet the definition of an insurance contract under IFRS 4 *Insurance Contracts*.

31. Accordingly, the staff thinks that the recognition of a deferred annuity only from the beginning of annuitisation phase would be an unintended consequence of the recognition point decision.

Staff recommendation

32. The staff recommends that the recognition point should be revised as follows (highlighted in italics) to clarify the recognition point for deferred annuities while not changing the recognition point for other insurance contracts:

    > An entity shall recognise an insurance contract it issues from *the earlier of*:
    >
    > (a) the start of the coverage period; *and*
    >
    > *(b) the date on which the first premium becomes due. In the absence of a contractual due date, the first premium is deemed to be due when received.*

33. The staff is mindful of the boards' intention in revising the recognition point to the start of the coverage period—ie to avoid unnecessary administrative complexity—and do not wish to recommend changes that would defeat that intention. This is why the staff recommends that, in general, the recognition point should depend on the date on which the first premium is *due*, rather than the date on which the first premium is *received*. Typically, the first premium is *due* at the start of the coverage period and insurers recognise insurance contract assets and liabilities from that date. However, the first premium may be *received* a few days or weeks before then. A general requirement to recognise contracts when the first premium is received could impose a change in practice and administrative burdens on insurers for no significant benefit.

34. For contracts in which there is no contractual premium due date, an alternative requirement is necessary. The staff thinks that, in these situations, coverage should begin on the receipt of the premium. Because deferred annuities do not have a contractual due date for the premiums, the revisions above will clarify that the recognition point for deferred annuities is on the receipt of the premium.

Taxes

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35. Respondents to the exposure draft had raised two matters pertaining to the treatment of taxes as follows:

    (a) income taxes included in fulfilment cash flows (paragraphs 36-42); and

    (b) discounting deferred taxes (paragraphs 43-45).

Income taxes included in fulfilment cash flows

36. Paragraph B61(h) requires that the fulfilment cash flows should include transaction-based taxes and levies that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

37. Paragraph B62(g) of the ED states that income tax payments and receipts should not be considered in estimating fulfilment cash flows. Such payments and receipts are recognised, measured and presented separately in accordance with IAS 12 *Income Taxes.*

38. Paragraph B62(g) was meant to exclude tax cash flows that are within the scope of IAS 12 *Income Taxes* from the estimation of fulfilment cash flows based on which insurance contact liabilities are computed.

39. Some comment letters questioned whether income tax payments and receipts should always be excluded from the fulfilment cash flows. Some argue that in some cases, policyholders' tax directly relates to the insurance contract or contract activities and should be included in the fulfilment cash flows. In particular, they believe that a distinction needs to be made between taxes imposed on the profits of an insurer (which would be appropriately dealt with under IAS 12) and taxes that are charged to the insurer as a proxy for taxing the policyholders directly (which they believe should be one of the contractual cash outflows to be included in the measurement of the liability).

40. Accordingly, they suggest that paragraph B62(g) should be amended to clarify that it excludes from the fulfilment cash flows taxes on the profits of an insurer but includes taxes paid on behalf of policyholders. The staff agree that it would be

consistent with the principle in the model to include policyholder taxes in the fulfilment cash flows if those taxes are incremental cash flows that arise as the insurer fulfils the insurance contract.

Staff recommendation

41. The staff recommends that the IASB should clarify that cash flows relating to tax payments should be evaluated and treated like any other cash flows. Thus, those cash flows that are related to fulfilling the contract would be included in the measurement of the liability.

42. We propose to clarify in paragraph B62(g) that the cash flows excluded from the fulfilment cash flows are income tax payments and receipts *that do not arise as the insurer fulfils the contract*.

Discounting of future income tax

43. A small number of respondents from specific tax jurisdictions raised a more technical concern on the treatment of tax payments. To the extent that taxes arising from insurance contracts are included in cash flows, these respondents note that the taxes would be treated similar to other cash flows and be discounted.

44. However, to the extent that taxes arising from insurance contracts are not included in the cash flows, these taxes will be measured in accordance with IAS 12 *Income Taxes.* This may be the case where the insurer does not consider the taxes to be part of the fulfilment cash flows of the insurance contracts. IAS 12 requires that deferred tax assets and liabilities are measured on an *undiscounted* basis. The respondents believe that these deferred taxes should be discounted. These respondents noted that the time value of money associated with deferred taxes could be a material item for long-duration insurance contracts.

Staff recommendation

45. The staff believes that the discounting of deferred tax treated in accordance with IAS 12 is beyond the reasonable scope of the insurance project and proposes not to perform any further work on the issue.

Tacit renewals

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46. In some countries, insurers implement an automatic renewal system (tacit renewal). Under this system an insurance contract will automatically renew unless one of the parties to the contact explicitly opts out of the new contract or opts out of the automatic renewal option. Contracts may renew at the same premiums or at a new premium because of reassessment of risk. Some have asked for additional guidance on tacit renewals.

Staff recommendation

47. The staff recommends not including specific guidance related to these matters in the proposed Standard. The staff believes that tentative decisions reached to date by the IASB relating to contract boundary, including contract renewals, would enable preparers to assess whether tacit renewals would fall within the contract boundary.

Cash bonus

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48. Some insurers (in particular short-term insurers) have introduced a rewards programme whereby a policyholder is rewarded for good behaviour, eg a cash payment for non-submittal of claims over a period of time. Some have asked for additional guidance on the treatment of cash bonuses.

49. These contracts often create an incentive for a policyholder to stay insured with the same insurer for a longer period to claim this bonus – eg if the policyholder does not claim for 3 years, the policyholder receives 25 per cent of paid premiums back. If the policyholder does not submit a claim in year 1, the policyholder would have an incentive to continue with the insurance until the end of 3 years to receive the bonus.

50. In both cases issues arise on accounting for the insurance contract, including:

    (a) What would be the contract boundary period (ie would the contract boundary change because of these clauses)?

    (b) Would the insurer qualify to apply the premium allocation approach?

    (c) How should the cash flows be treated in the case of a cash bonus?

    (d) Are there deposit components in the cash bonus contracts?

51. The staff believes that there is sufficient information in the cash flows guidance for entities to apply to these types of contracts. The staff thinks the general guidance on which contracts fall within the contract boundary and on defining deposit components would apply. Having determined the contract boundary, the insurer would be able to assess whether the contract meets the 12-month expedient for eligibility for the premium allocation approach. Otherwise, the insurer would need to assess the contract against the general criteria for eligibility for the premium allocation approach. Because there can be many small variations between contracts, the staff do not propose that the IASB should provide more guidance specifically for these contracts.

Staff recommendation

52. The staff recommends not including specific guidance related to these matters in the proposed Standard.

Reinsurance Contracts held by cedant— unfavourable changes that adjust the positive residual margin

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53. For reinsurance contracts that the cedant holds, the cash outflows represents the premiums paid to the reinsurer and the cash inflows are the reinsurer's share of the expected present value of the expected cash flows generated by the underlying direct insurance contract(s). The IASB's current tentative decision requires the recognition of the residual margin on day one when the net expected present value of cash flows are negative (ie cash outflows exceed cash inflows).

54. In reaching this decision, the IASB believed that the excess amount represents the cost to purchase reinsurance. Consequently, the residual margin is a positive amount (ie a debit balance) and the reinsurance asset recognised equals the premium paid to the reinsurer. That cost (ie the positive residual margin) is then recognised in profit or loss as services are transferred under the contract.

55. After initial recognition, the cedant would adjust the residual margin for favourable or unfavourable changes in expected cash flows relating to future coverage or other future services.[5] Unfavourable changes are:

    (a) a decrease of expected cash inflows representing a decrease in the reinsurer's share of the expected present value of the expected cash flows generated by the underlying direct insurance contract(s); and

    (b) an increase in the premiums paid to the reinsurer.

    When the residual margin is positive, the unfavourable changes increase the positive margin. However, the reinsurance asset recognised still equals the premiums paid to the reinsurer (ignoring any allocation). This is consistent with the reinsurance asset recognised at inception (discussed in paragraph 54).

56. During the IASB's December 2012 meeting, some board members requested the staff consider limiting the increase of the positive residual margin due to changes in estimates that are unfavourable after inception. Consequently, this section considers whether there should be a limit to the unfavourable adjustments against a positive residual margin for reinsurance contracts held by a cedant.

57. Arguments for such a limit are that:

    (a) Some are concerned that current losses can be deferred by increasing the positive residual margin.

    (b) Others may prefer a limit because for direct insurance contracts, there is a limit to unfavourable adjustments against the margin by setting the floor of the margin to zero. Once the residual margin is exhausted for

[5] In December 2012 the IASB decided that changes in expected credit losses do not represent changes in future coverage or other future services. Consequently, a cedant would recognise immediately in profit or loss changes in expected credit losses.

direct insurance contracts, further unfavourable changes are recognised immediately in profit or loss.

58. Staff recommends that the IASB confirms the current decision—that no limit be imposed on unfavourable adjustments against a positive residual margin because of the following reasons:

(a) It is consistent with the board's rationale for unlocking the residual margin for direct insurance contract because:

(i) for the *direct insurance contract,* the residual margin represents the unearned profit For a *reinsurance contract*, the *positive residual margin* reflects a view of the residual margin as the unconsumed cost of the reinsurance contract. Applying this view, a cedant should measure the residual margin on day one as the difference between the present value of the premiums paid and the present value of the cash inflows received representing the reinsurer's share of the direct insurance contract. If there is a change in the cash flows, the reinsurance contract costs more or less than estimated on day one. If the change relates to estimates of *future* cash flows (as opposed to experience adjustments), it increases or decreases the *unconsumed* cost of reinsurance. Therefore, the remaining residual margin should be adjusted to achieve consistency between inception and subsequent measurement of the reinsurance contract.

(ii) changes in estimates against the residual margin could reduce manipulation of results, ie estimates of day 1 and day 2 is treated consistently.

(b) In response to the concern that the lack of any limit may mean that *current* losses are deferred to future periods (discussed in 57(a)), staff notes that unfavourable adjustments that relate to the *current and past* periods are already required to be recognised in profit or loss under the IASB's current decisions.

(c) In response to the arguments discussed in 57(b), staff notes that for the *direct contracts* the limit on unfavourable changes by setting the floor to the margin to zero is consistent with the treatment of the margin on

day one (ie the margin can never be negative on day one or subsequently). However, a symmetrical treatment does not apply to *reinsurance assets*. For reinsurance assets, a negative residual margin can be recognised on day one and subsequently because this represents the unearned profit in the *reinsurance contract.*

(d) It is simpler. If a limit was introduced to the unfavourable adjustments against the positive residual margin, there are two costlier alternatives which may not result in better information:

(i) Alternative 1—all unfavourable changes are immediately recognised in profit or loss. Effectively the limit is the current carrying value of the residual margin. From an operational standpoint, this is less complex than Alternative 2. However, favourable and unfavourable adjustments would be treated inconsistently.

(ii) Alternative 2—limit the positive residual margin to the amount recognised on day one. Any unfavourable adjustments can increase the positive margin so long as it does not exceed the amount recognised on day one. After the limit is reached, unfavourable adjustments are recognised in profit or loss. Staff thinks is this operationally burdensome because the insurer will be required to track the amount recognised at inception. In addition, the IASB would need to consider whether the limit should consider the allocations to profit and loss already recognised in the past. This is the reason why the residual margin for direct contracts is adjusted on a prospective basis.

Staff recommendation

59. The staff recommends that the IASB confirms the current decision—that no limits be imposed on unfavourable adjustments against a positive residual margin for reinsurance contracts that a cedant holds.

Treatment of ceding commission in cedant's financial statements

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60. Reinsurers sometimes compensate the cedant (in form of ceding commission) for various expenses that the cedant incurs for writing the underlying contracts such as underwriting expenses or acquisition costs related to those contracts. Ceding commissions may also include some profit margin.

61. The ED proposed that a cedant should treat ceding commissions as a reduction of premiums ceded to reinsurer and present the net amount in the statement of comprehensive income as ceded premiums.

62. A small number of respondents disagreed with this treatment because they believed that such presentation would distort the information presented in cedant's statement of comprehensive income. Some were also worried that ratios between direct and net business might be distorted as a result of this proposal. These respondents proposed that the ceding commissions and ceded premiums should be split and that the ceding commissions related to reimbursement of expenses should be presented adjacent to those expense line items.

63. The staff believe that in practice such a split would not be simple for all contracts and therefore could result in arbitrary outcomes (especially for contracts that do not have explicit ceding commission because the reimbursement of expenses is included in premium ceded). The staff believe that for these contracts, the benefit of providing such information would most likely not outweigh the cost of obtaining it.

Staff recommendation

64. The staff recommends that the IASB should confirm the proposal in the ED that insurers should treat ceding commission as the reduction of premiums ceded to the reinsurer.

Alignment of the allocation pattern for the premium in the premium allocation approach with the residual margin in the building block approach

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65. The proposed Insurance Contracts Standard proposes two approaches to account for contracts, namely:

    (a) the building block approach (BBA): in this model the income released to profit or loss comprises the release of the risk and residual margins; and

    (b) the premium allocation approach (PAA): this is a simplification of the BBA, in which the income released to profit or loss would comprise the release of the liability for remaining coverage.

66. The ED proposed that an entity should reduce both the liability for remaining coverage in the PAA and the residual margin in the BBA in a systematic way that best reflects the exposure from providing insurance coverage either on:

    (a) the basis of the passage of time; or

    (b) the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time (paragraph 58 for the PAA and paragraph 50 for the BBA).

67. However, in June 2011 the IASB tentatively decided that an insurer should allocate the residual margin over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract.

68. The reason for this decision was to respond to comments that the ED proposal was too prescriptive and that it would be better to state the underlying principle, ie that the residual margin should be allocated in line with the pattern of transfer of services. This decision aligned the principles and wording of release of the residual margin with the draft Standard *Revenue from Contracts with Customers*. The allocation of the liability for remaining coverage was not discussed at the time.

69. In the view of the staff, the reason for modifying the allocation of the residual margin in the building block approach applies equally to the liability for remaining coverage in the premium allocation approach. It would also be consistent with the view of the premium allocation approach being a proxy for the building block approach.

Staff recommendation

70. The staff recommends that the IASB should align the requirements to reduce the liability for remaining coverage to the requirements for releasing the residual margin, ie that an entity should reduce the liability for remaining coverage premium over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract.

Disclosure of maturity analysis (liquidity) for contracts accounted for using the premium allocation approach

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71. The IASB decided that an insurer should disclose a maturity analysis of net cash flows resulting from recognised insurance liabilities. This disclosure would provide information that the insurer uses to measure contracts accounted for using the building block approach. However, for contracts accounted for using the premium allocation approach, the insurer is not required to estimate cash outflows for the liability for remaining coverage as long as the contract is not onerous.

72. The staff believes that the objective of the information provided by this disclosure is to present expected liquidity. Consequently, the staff believes that disclosure of the expected cash outflows would be onerous and that disclosure of cash inflows would not meet the objective of this disclosure. Consequently, the staff recommends that the insurer should be relieved from providing disclosure about the maturity analysis of cash flows for the liability for remaining coverage for contracts accounted for using the premium allocation approach.

Staff recommendation

73. The staff recommends that the insurer should be relieved from providing disclosure about the maturity analysis of cash flows for the liability for remaining coverage for contracts accounted for using the premium allocation approach.

Business combinations and portfolio transfers

74. Respondents to the ED raised the following matters pertaining to business combinations and portfolio transfers:

    (a) acquiring a portfolio as part of a business combination or as a portfolio transfer (paragraphs 75-78);

    (b) allocation of the residual margin (paragraphs 79-82); and

    (c) transition (paragraphs 83-89).

    The staff notes that the FASB discussed these issues at its meeting on 14 November 2012.

Acquiring a portfolio (business combination) and portfolio transfers

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75. The ED proposed differing treatments for business combinations and portfolio transfers. When an insurer assumes an insurance contract liability, it typically receives consideration from the transferor. In a business combination, that consideration is deemed to be the fair value of the insurance contract assumed. The ED proposed that if the insurer assumes an insurance contract liability, it should treat that consideration as a premium received at initial recognition. Thus, when the consideration exceeds the present value of fulfilment cash flows, that excess would establish a residual margin. However, when the consideration is less than the present value of fulfilment cash flows, the insurer would recognise:

    (a) an immediate expense, in a portfolio transfer; or

(b) an increase in the amount of goodwill recognised in the business combination.

76. In developing the ED, the IASB concluded that this difference was justified because, applying IFRS 3 *Business Combinations*, excess consideration over the fair value of assets and liabilities would be treated as goodwill in a business combination. That is not the case when there is no business combination.

77. A few respondents expressed concern that it would be difficult to distinguish between a business combination and a portfolio transfer and requested that the same guidance should be applied for both types of transactions. Those concerns had been discussed with the IASB in developing the proposals in the ED. The issue was not widely raised in the comment letters, which raised no new arguments. Furthermore, the staff note that the identification of whether a transaction meets the definition of a business combination is prescribed by IFRS 3 and widely applied in IFRSs.

Staff recommendation

78. The staff recommends carrying forward the proposals in the ED, ie business combinations and portfolio transfers would be treated differently.

Allocation period of residual margin—Business combinations and portfolio transfers

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79. Some respondents indicated that the boards need to specify the pattern of allocation for the residual margin for insurance contracts acquired in a business combination or portfolio transfer. They noted that, especially for portfolio transfers, the contracts assumed may not have an unexpired coverage period. This would be the case when the contracts cover losses on insured events that have already occurred. Accordingly they questioned over what period the residual margin should be recognised.

80. In the staff's view, the ED's depiction of a portfolio transfer or business combination is that the acquirer receives a premium in return for assuming an uncertain liability. Thus, when contracts do not have an unexpired coverage period, the insured event is the discovery of a loss during the remaining settlement period. This situation is discussed in paragraphs B4 and B5 of the ED as follows:

> B4 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contact. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.
>
> B5 Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims.

81. Accordingly, the staff think that the residual margin should be allocated over the period of expected settlement, and that no further guidance is necessary.

Staff recommendation

82. The staff recommends no action.

Transition—Business combination

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83. The IASB has decided that an insurer should use a simplified retrospective approach for first time application of the Insurance Contracts Standard. This means that if the insurer were to use this approach at transition, it would need to

determine which in-force contracts were acquired as a result of past business combinations and account for those differently from in-force contracts that the insurer had originated itself. Consequently, for contracts that are acquired through a business combination, the insurer would need to apply the guidance for the business combination for insurance contracts retrospectively. For those contracts, the insurer would need to:

(a) determine the fair value of insurance contracts at the business combination date and book a difference between fair value and fulfilment cash flows at that date as a residual margin or goodwill; and

(b) establish the locked-in discount rate at that date.

84. The advantages of this approach are as follows:

(a) it is consistent with retrospective application of the Standard, ie applying the Standard as it had always been applied, the insurer would account for those contracts according to the business combination guidance.

(b) It also might be easier for some contracts to establish their fair value at the business combination date, rather than calculating estimates at inception, especially if the transaction took place close to the transition date.

(c) Moreover, using the locked-in discount rate at the business combination date is arguably more reflective of the business assumptions related to those contracts than the locked-in rate at inception.

85. However, such an approach might add complexity if the insurer had multiple business combinations prior to transition that took place a long time ago because it would require assessment of the fulfilment value and the fair value of those contracts at the business combination date.

86. Alternatively, the insurer could account for all in-force contracts the same way, irrespective of the form of origination of the contract, based on the general transition requirements, ie:

(a) establish the margin through retrospective application with simplifications; and

(b) establish the locked-in discount rate at inception.

87. As a consequence of using this approach, there would be impaired comparability between accounting for business combinations before and after transition. As noted above, the main difference should occur with respect to the locked-in discount rate and the absence of goodwill. Moreover, some might argue that this approach would not reflect the economics of this contract appropriately, especially in relation to the locked-in discount rate. On the other hand, because of the simplifications that are introduced for residual margin calculations, it should be easier to apply a similar approach for all contracts that are in-force at the date of transition.

88. The staff believes that both approaches have their challenges. The retrospective application of the Standard would provide comparability between business combinations before and after transition. However, the staff believes that it would be difficult to establish the fair value of insurance contracts at the date of each business combination (as discussed in paragraph 85). Consequently, the staff recommends that at transition an insurer should not distinguish contracts on the basis of their origination. This would mean that all in force contracts would be treated similarly on transition (ie that contracts acquired as part of a business combination would be accounted as though the insurer had had them since inception).

Staff recommendation

89. The staff recommends that, to measure insurance contracts on transition, an insurer shall assume that all contracts had been originated by the entity, ie that they had not been acquired in a previous business combination or portfolio transfer.

Implementation guidance in IFRS 4

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90. The July 2010 ED did not propose to carry forward the Implementation Guidance accompanying IFRS 4. That guidance provided:

    (a) examples of how to apply the definition of insurance contracts;

    (b) examples of how to unbundle embedded derivatives and deposit components;

    (c) a discussion of, and an example of, shadow accounting, a practice that was permitted but not required by IFRS 4; and

    (d) application guidance on the disclosures, most of which were proposed in the Exposure Draft for inclusion in the Standard.

    (We have not reproduced the Implementation Guidance because of its length, which is 41 pages).

91. The staff notes that the Implementation Guidance of IFRS 4 accompanied, but was not part of, IFRS 4. In the staff's view, it is unnecessary to carry forward this non-mandatory Implementation Guidance, because:

    (a) the perceived need for examples on how to apply the definition of insurance contracts and the embedded derivatives and deposit components at the time that IFRS 4 was published reflected the fact that those requirements were unfamiliar to many insurers. However, now that IFRS 4 has been in place for many years, that need is less. (Even for first-time adopters, there is existing practice on which to draw. That was not the case when IFRS 4 was published.);

    (b) providing lists of examples illustrating the scope of the Standard and the treatment of embedded derivatives under the insurance Standard and IFRS 9 would be rules-based and risks the possibility that entities will focus on the examples rather than the principles;

    (c) the new Standard will not refer to shadow accounting; and

(d) the relevant parts of the Implementation Guidance on disclosures had already been incorporated in the proposals in the ED.

Staff recommendation

92. The staff recommends that the IASB should not carry forward the Implementation Guidance that currently accompanies IFRS 4 to the new standard.