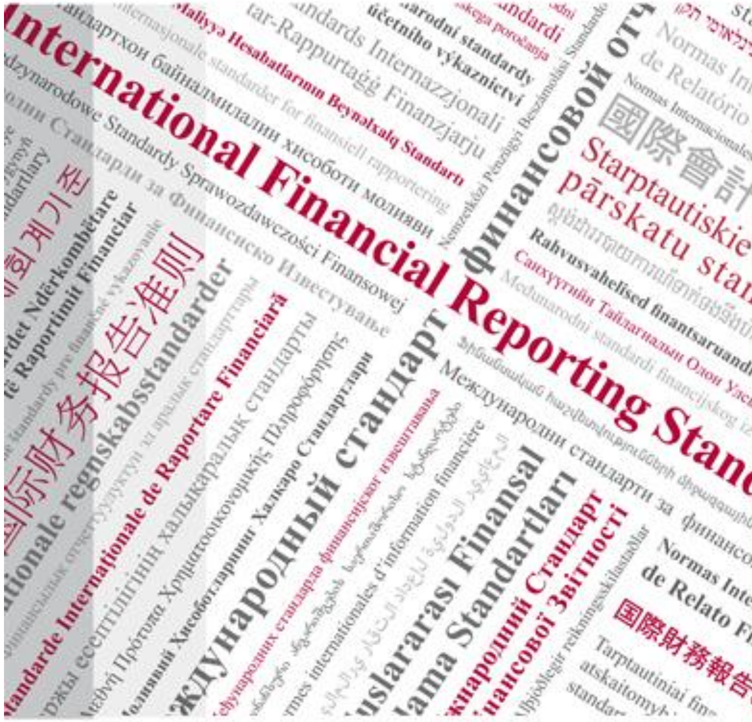

Accounting Standards Advisory Forum (ASAF)
September 2013 agenda paper 2

ED *Insurance Contracts*

An overview of proposals

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Background to insurance contract proposals: No comprehensive IFRS today

IFRS 4 *Insurance Contracts* is an interim Standard

- Permits continuation of a wide variety of accounting models
- Requires disclosures to enhance comparability and to understand reported amounts
- Does not facilitate transparency

We have listened and responded to your concerns

- Improves representation of some aspects
- Introduces practical accommodations to conceptual approaches
- Provides additional clarification and guidance

Revised Exposure Draft (ED) next step toward final Standard

- Builds on previous consultations
- Seeks feedback on changes to previous proposals
- Focuses on operational and reporting complexity of revised proposals

Background to insurance contract proposals: Improving existing accounting

Existing issues	How our proposals improve accounting
Variety of accounting treatments depending on type of contract and type of company that issues the contracts	Consistent accounting for all insurance contracts by <u>all</u> companies (not just insurance companies)
Estimates for long duration contracts not updated	Estimates updated to reflect current market-based information
Discount rate based on estimates of investment returns does not reflect economic risks of insurance contract	Discount rate reflects characteristics of the cash flows of the contract
Lack of discounting for measurement of some contracts	Measurement of insurance contract reflects discounting where significant
Little information about economic value of embedded options and guarantees	Measurement reflects information about full range of possible outcomes

Who is affected by these proposals?

- Any entity that issues:
  - All types of insurance contracts
  - Some types of fixed-fee service contracts
  - Third-party product warranties
- In addition, if an entity issues insurance contracts, the proposals also apply to:
  - Investment contracts that contain discretionary participation features
  - Reinsurance contracts held (ie where the entity is the cedant)

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Impact for different types of insurance contracts

The same principles apply to all types of insurance contracts

Life contracts

- Current, updated estimates of cash flows
- Explicit estimates of risk
- Discount rates that fully reflect insurance contract cash flow characteristics
- Reporting revenue for services rather than cash-based premium information
- Elimination of deferred acquisition cost assets

Non-life contracts

- Restrictions on eligibility for premium allocation approach
- Little change to reporting during coverage period
- More change to accounting for incurred claims
  - risk adjustment
  - discounting
  - other comprehensive income

Reinsurance contracts held

- Many reinsurance contracts eligible for premium allocation approach
- Reported using consistent methodology as for direct contracts

Our proposals: Current, market-consistent measurement of insurance contracts

Measurement of insurance contract has two components:

Net contract asset or liability*

Contractual service margin:
Expected contract profit

Fulfilment cash flows

Future cash flows: Expected cash flows from premiums and claims and benefits

Risk adjustment: An assessment of the uncertainty about the amount of future cash flows

Discounting: An adjustment that converts future cash flows into current amounts

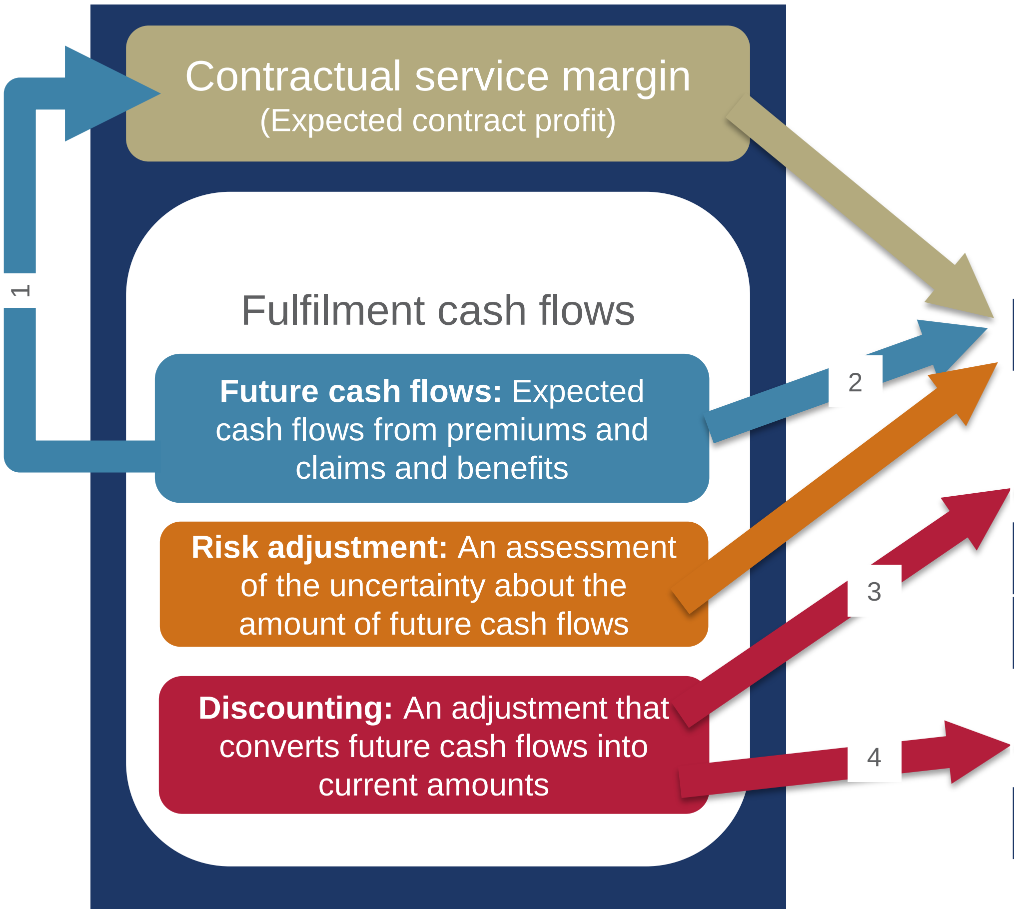
Contractual service margin represents expected contract profit

Fulfilment cash flows represent a current, updated estimate of amounts the company expects to collect from premiums and pay out for claims, benefits and expenses, adjusted for risk and time value of money

* Depending on the timing of payments relative to coverage provided

Our proposals: Up-to-date information about performance

Net contract asset or liability



Statement of Comprehensive Income

	20XX
Insurance contracts revenue	X
Incurred claims and expenses	(X)
Operating result	**X**
Investment income	X
Interest on insurance liability	(X)
Investment result	**X**
Profit or loss	**X**
Effect of discount rate changes on insurance liability	(X)
Total comprehensive income	**XX**

1. Changes in estimates relating to future services
2. All other expected cash flow changes
3. Based on a cost view
4. Based on a current view

Our proposals: What will disclosures show?

Amounts

- Expected present value of future payments & receipts
- Changes in risk during the period
- Changes in expected contract profit
- Effects of new contracts written in the period

Judgements

- Processes for estimating inputs and methods used
- Effect of changes on methods and inputs used
- Explanation of reason for change, identifying type of contracts affected

Risks

- Nature and extent of risks arising from insurance contracts
- Extent of mitigation of risks arising from reinsurance and participation features
- Quantitative information about exposure to credit, market and liquidity risk

IASB seeks feedback on targeted aspects

Measurement proposals

- Changes in estimates relating to expected contract profit for providing coverage recognised over remaining period
- Measurement and presentation exception when no economic mismatch is possible

Presentation proposals

- Align to presentation of revenue required for other types of contracts with customers
- Interest expense is amortised cost-based in profit or loss, current value-based on balance sheet

Approach to transition

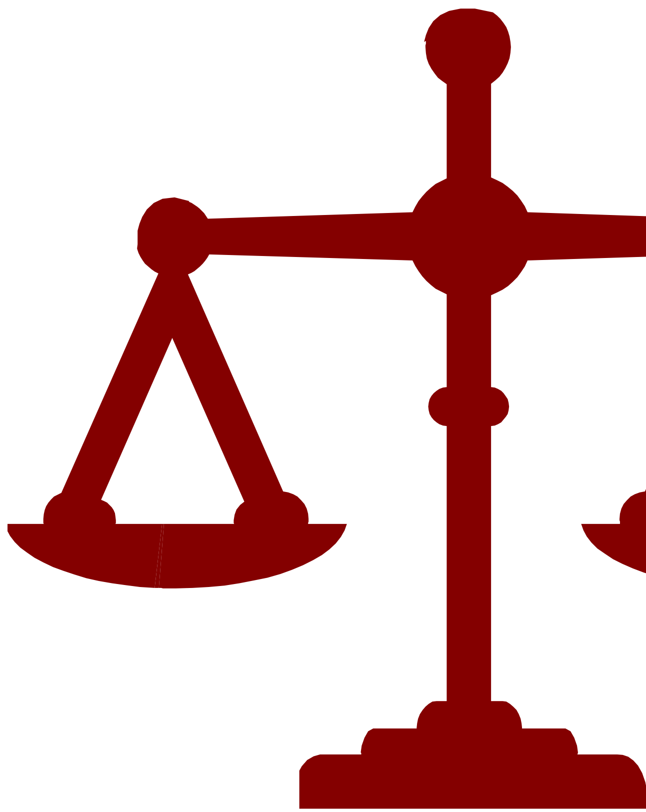
- Apply Standard retrospectively if practicable, or with specified simplifications if not practicable

Impact on different types of contract

	Life contracts	Non-life contracts	Reinsurance contracts (cedants)
Changes in estimates relating to future profits	Most impact	Not relevant if using premium allocation approach	Not relevant if using premium allocation approach
Measurement and presentation exception when no economic mismatch is possible	Significant impact for eligible contracts	Not relevant if using premium allocation approach	Not relevant if using premium allocation approach
Insurance contract revenue	Significant impact	Less impact as similar to existing practice	Less impact if using the premium allocation approach
Interest expense in amortised cost basis	Significant impact	Significant impact for the liability for incurred claims	Significant impact
Transition	Significant impact	Significant impact for the liability for incurred claims	Significant impact

Balancing benefits against complexity

Better reflection of the economics of the contracts

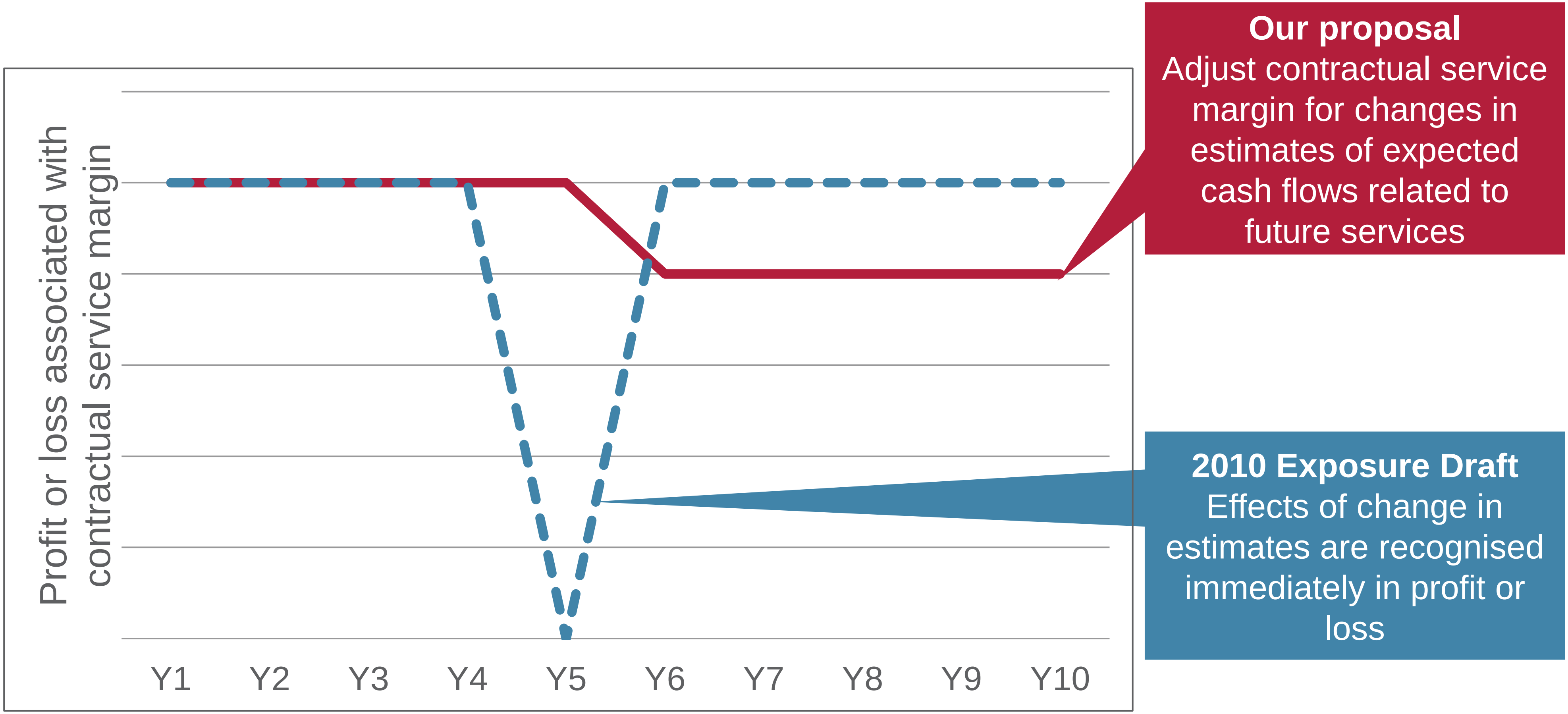


Costs of greater operational complexity for preparers and of understanding more complex information for users

Issue: Adjustments for changes in cash flows relating to future insurance coverage

Changes in estimates of cash flows affect the amount of profit the company expects to earn for providing future services. Should such changes in estimates be reported in the period of change or as future services are provided?

Pattern of profit recognition after change in estimates relating to future insurance coverage



Change since 2010 ED: Adjustments for changes in cash flows relating to future insurance coverage

Our proposal

Adjust contractual service margin for changes in future cash flows related to future services

- Better reflects that these changes affect expected contract profit for providing future services
- Results in consistency between initial and subsequent measurement of contractual service margin
- For periods after change in estimate, updated estimates included in future operating results as services are provided
- Consistent with revenue recognition model and premium-allocation approach

2010 proposal

- Changes in estimates for both past and future services represent economic events during the period and should immediately be recognised in profit or loss
- Immediately recognising in profit or loss changes in expected future profits provides transparent, relevant information of changes in estimates since entering into the contract
- For periods after change in estimates, profit based on original estimates for future services
- Consistent with balance sheet view and IFRS 9

Issue: Contracts that have cash flows that are expected to vary directly with returns on underlying items

If an insurance contract specifies a link to returns on underlying items the company is required to hold, there can be no economic mismatch between the cash flows that vary directly with returns on underlying items and those returns.

How do we portray that fact?

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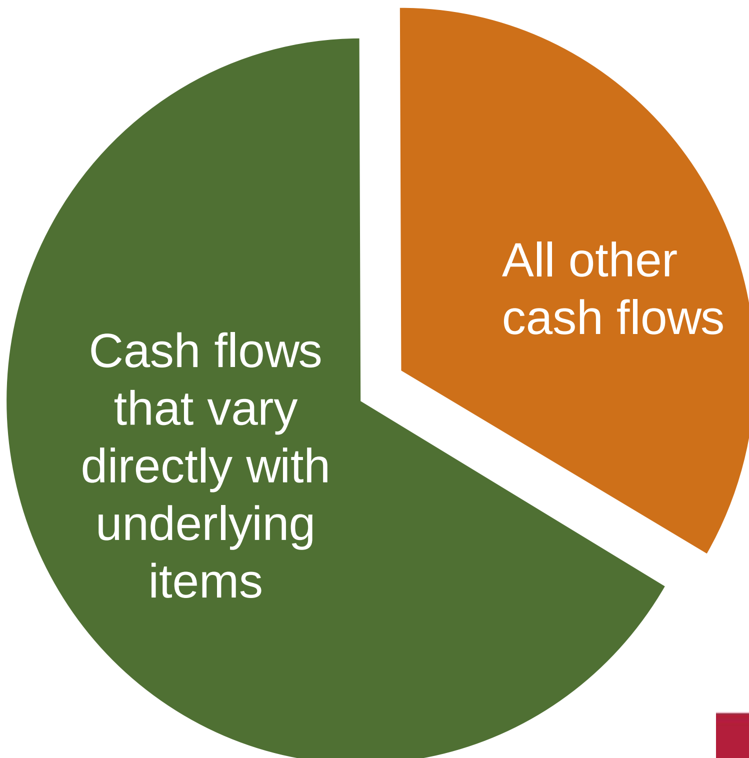
Measurement and presentation exception

Applies when there can be no economic mismatch between the insurance contract and assets backing that contract. This occurs when the contract requires the entity to hold underlying items and specifies a link to returns on those underlying items.



Measured using general requirements of the Standard. However, all changes in value of cash flows that vary indirectly with the underlying items are presented in profit or loss

Eliminate mismatch by measuring and presenting cash flows in the same way as the underlying items.

Change since 2010 ED: Contracts that have cash flows that are expected to vary directly with returns on underlying items

Our proposal

- Measures cash flows that arise from underlying items on the same basis as underlying items. This reflects that the entity will fulfil the obligation by delivering a value equivalent to the underlying item to the policyholder
- Aligns accounting with economics:
  - No accounting mismatch when there is no possibility of economic mismatch
  - Portrays economic risks borne by the entity

2010 proposal

- Measures insurance contract liability using fulfilment cash flows (with no adjustment to reflect contractual linkage to underlying items). This would:
  - result in measuring all insurance contracts on same current value basis
  - substantially eliminate measurement mismatches when underlying items are measured at fair value

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Issue: Insurance contract revenue and expense

Should a company show information about gross performance rather than net margin?

If gross performance is more useful, should information be consistent with revenue and expense for other transactions?

Proposed change to presentation does not affect operating result

2010 Exposure draft:
Summarised margin presentation

Change in contractual service margin

+ Change in risk adjustment

± Experience adjustments

= Operating result

Change in contractual service margin

+ Change in risk adjustment

± Claims/expenses expected

- Claims/expenses incurred

= Operating result

Combine

Combine

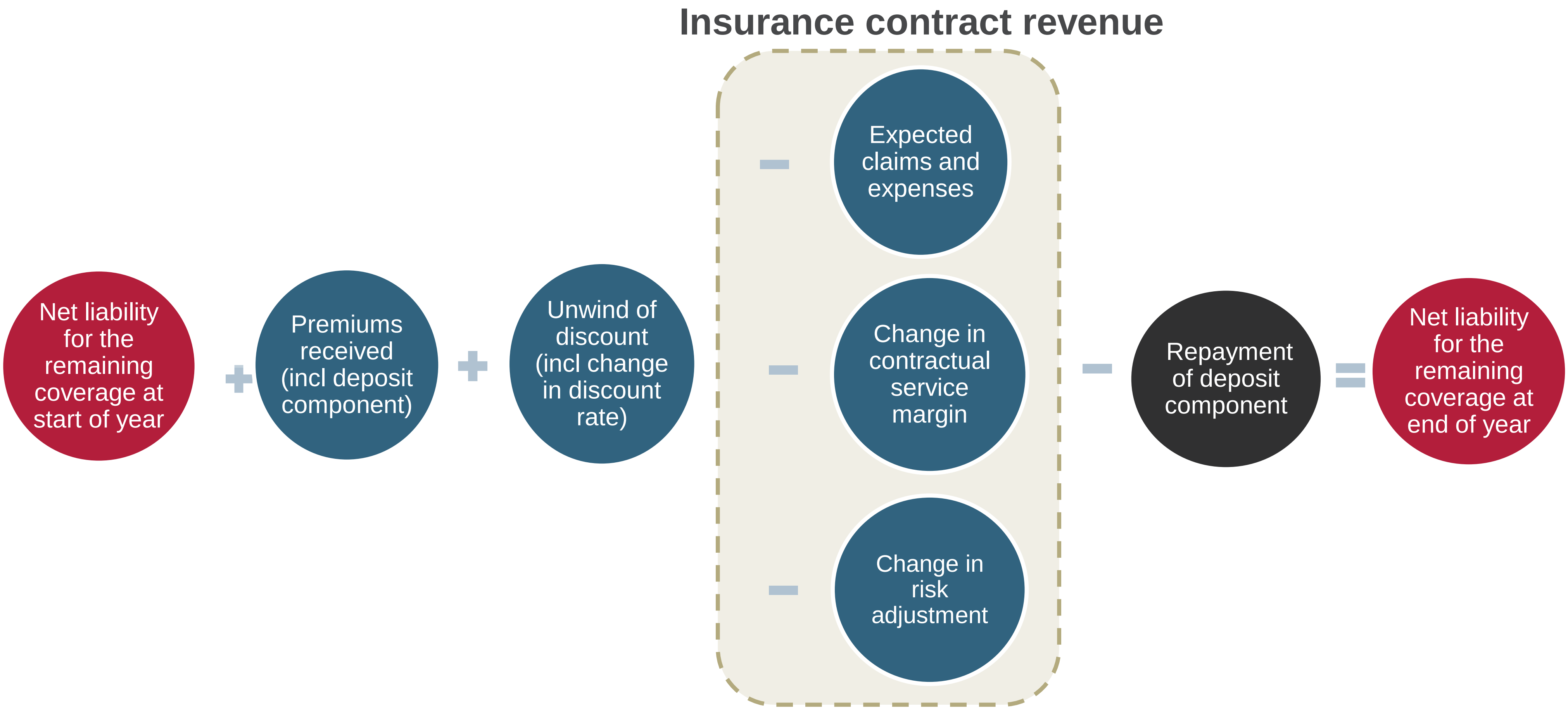
Our proposals:
Gross performance metrics

Insurance contracts revenue

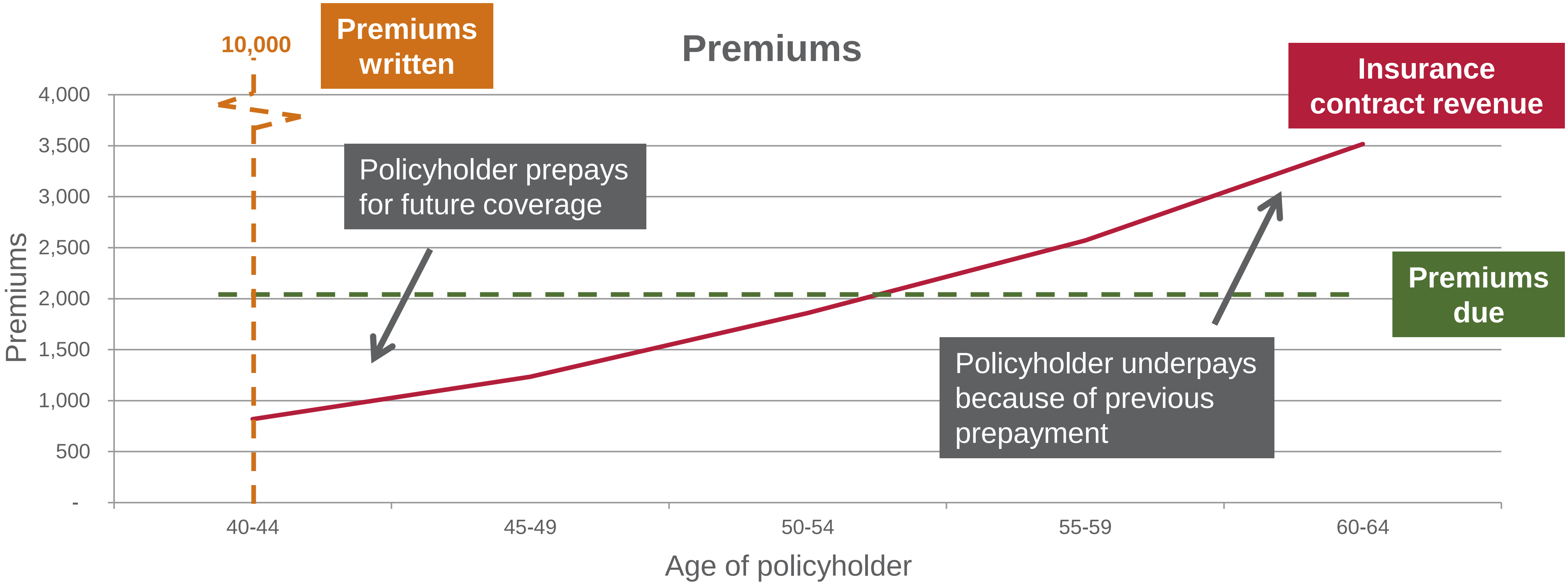
- Claims/expenses incurred

= Operating result

How revenue relates to changes in the measurement of the insurance contract



What is revenue from insurance contracts? Level premium term life contract



- Assumptions:
  - Portfolio of term life contracts issued to 40 year olds
  - Expected claims/benefits are 10,000; premiums are due 2,000 each 5 year period
  - Ignores premiums ‘allocated’ to the margins, payment of acquisition costs and payment of maintenance and benefits expense
  - Assumes no lapses, no discounting and no investment component

Change since 2010 ED: Presentation of interest contract revenue and expense

Our proposal: Gross performance metrics

- Present insurance contract revenue and incurred claims/expenses
- Enables results from insurance services to be compared to results of other services provided (by insurance or non-insurance companies)
- Consistent with treatment of deposits by other financial services entities

2010 proposal: Net performance metrics

- Present operating result, disaggregated into:
  - Change in contractual service margin
  - Change in risk
  - Changes in expected cash flows for current and past service
- Highlights drivers of performance. Also simpler to apply as avoids need to identify deposit component

Issue: Determining interest expense

Should companies be required to separate the results from underwriting and investment activities from the effects of the changes in discount rates?

Our proposal: Interest expense presented in profit or loss reflects a cost view

Statement of Comprehensive Income

	20XX
Operating (underwriting) result	X
Investment income	X
Interest expense (on insurance liability)	(X)
Investment result	X
Profit or loss	X
Effect of discount rate changes on insurance liability***	(X)
Total comprehensive income	XX

Profit or loss
Reflects the profit or loss from services using an amortised cost view of the time value of money**

Total comprehensive income
Reflects the profit or loss of providing services using a current view of the time value of money***

**the amortised cost view uses the discount rate determined at contract inception, and current view uses the current discount rate at reporting date

*** The 'effect of discount rate changes' reconciles the current view and the amortised cost view of performance, assuming financial assets are measured at fair value through other comprehensive income

Change since 2010 ED: Interest expense presentation in profit or loss

Our proposal

- Separates results from underwriting and investing activities from the effect of changes in discount rates in a way that aligns to proposals for financial assets at fair value through other comprehensive income.
- Two types of information provided:
  - An amortised cost-based interest expense in profit or loss
  - a current measurement balance sheet

2010 proposal

- Present the changes in the insurance contract liability arising from changes in the discount rate in **profit or loss**. This:
  - avoids reporting complexity
  - provides information about all economic gains and losses in profit or loss
  - permits greater reduction of unavoidable mismatches if fair value options are used for assets

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An OCI option?

- Some suggest allowing entities to elect whether to use a 'cost-based' approach and OCI
  - Could reduce complexity for some preparers of financial statements
  - May reduce accounting mismatches
- However:
  - Lack of comparability
  - Additional complexity for users of financial statements
  - Unclear what would be best unit of account to apply option
  - May not reduce accounting mismatch:
    - if applied at 'wrong' unit of account
    - if election is irrevocable

Issue: Applying proposals for the first time

The challenge for first-time application is measuring the contractual service margin at the date of transition.

How do we balance verifiability of the amount recognised at transition date with comparability between contracts issued prior to and after transition date?

Applying the new accounting for the first time

Contractual service margin
(Expected contract profit)

Needs to be estimated

Estimate as if the Standard had always been applied, with simplifications that maximise the use of objective data if necessary

Fulfilment cash flows

Future cash flows: Expected cash flows from premiums and claims and benefits

Risk adjustment: An assessment of the uncertainty about the amount of future cash flows

Discounting: An adjustment that converts future cash flows into current amounts

Can be directly measured

Measure on date of first time application

Change since 2010 ED: Applying the proposals for the first time

Our proposal

- Estimating and recognising contractual service margin on transition enables users to compare profitability of existing contracts with new contracts

2010 proposal

- Setting contractual service margin to zero and measuring liability as fulfilment cash flows would be simple, cost little and would not involve subjective information in determining the margin

Timetable

20 June 2013
Revised Exposure Draft

25 Oct 2013
Comment letter deadline

H1 2014
Board debates issues

Early 2015
Issue IFRS

Effective date
Approx 3 years after Standard finalised

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Thank you

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