

## STAFF PAPER

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Project	Insurance contracts		
Paper topic	Rate used to accrete interest and calculate the present value of cash flows that unlock the contractual service margin		
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### Purpose of the paper

1. This paper considers whether the rate used to accrete interest on the contractual service margin and to calculate the present value of cash flows that offsets (unlocks) the contractual service margin should be:
  - (a) the current rate that is used for the measurement of the insurance contract at the end of the reporting period; or
  - (b) the locked-in rate that was used to determine the contractual service margin at initial recognition.
2. This paper considers only contracts without participating features. The staff will review the applicability of the Board's decisions to contracts with participating features in due course.

### Staff recommendation

3. The staff recommend that, for contracts without participating features, an entity should use the **locked-in** rate at the inception of the contract for accreting interest on the contractual service margin and for calculating the change in present value of expected cash flows that offsets that margin.

## Staff analysis

4. Using a current rate, rather than a locked-in rate, for accreting interest and unlocking the contractual service margin would cause differences in:
  - (a) the amount of the contractual service margin at the end of each reporting period and consequently the amount of the insurance contract liability in the balance sheet; and
  - (b) the amounts recognised as underwriting (operating) and investment result in each period and cumulatively. However, the cumulative amounts recognised in total comprehensive income over the contract term would be the same.
5. These differences are illustrated in the examples in Appendix A. Because the choice of rate creates differences in the measurement of the insurance contract, the staff believe that the IASB needs to specify which rate should be used.
6. The paragraphs that follow:
  - (a) consider which rate should be used for interest accretion (paragraphs 7-16).
  - (b) consider which rate should be used to determine the present value of cash flows used to unlock the contractual service margin (paragraphs 17-21).
  - (c) set out the staff recommendation (paragraphs 22-24).

## Accretion of interest

### *Rationale for the ED proposals*

7. The 2013 Exposure Draft *Insurance Contracts* (the 2013 ED) proposed that an entity should use the locked-in rate at inception to accrete interest on the contractual service margin. The IASB made this decision after seeking specific feedback on the 2010 Exposure Draft *Insurance Contract* (the 2010 ED) as to whether a locked-in or current rate should be used to accrete interest on the residual margin (the former name for the contractual service margin).

8. Some respondents to the 2010 ED had suggested that a current rate should be used, to be consistent with all the other components of the insurance contract liability. Those components are measured using a current rate.
9. However, in developing the 2013 ED, the IASB confirmed its 2010 proposal that the rate used to accrete interest should be locked-in at the inception of the contract. The IASB found the following arguments persuasive:
  - (a) a locked-in rate is conceptually correct because the interest accretion should reflect only the time difference between the initial recognition of the contract and the time when the service is provided, rather than reflecting the current price that the entity would charge for the service at the reporting date. In addition, using a locked-in rate treats the contractual service margin similarly to a pre-payment for non-insurance services in IFRS15 *Revenue from Contracts with Customers*. In accordance with IFRS 15, an entity would accrete interest using the rate at the inception of the contract. Consequently, using locked-in rates would improve the comparability of profits for services delivered for insurance and non-insurance contracts. (It would also be consistent with the premium allocation approach, which in effect uses locked-in rates, consistently with IFRS 15).
  - (b) the entity determines the contractual service margin at inception by taking into account the time value of money. Although the entity would unlock the contractual service margin for changes in estimates of cash flows, the entity does not unlock the contractual service margin for the effect of changes in discount rate (please refer to discussion about unlocking in paragraph 18). As a result, the contractual service margin implicitly reflects the time value as estimated on day one. Locking the rate used to accrete interest on the contractual service margin would be consistent with that approach.
  - (c) using a locked-in rate avoids some of the complexity associated with using a current rate, discussed in paragraphs 10-12.

*Complexity arising from using a current rate when effect of changes in discount rates are presented in OCI*

10. As noted in paragraph 9(c), some problems can arise if a current rate is used and an entity chooses to present the effect of changes in discount rate in Other Comprehensive Income (OCI).<sup>1</sup> When an entity chooses to present the effect of changes in discount rates in OCI the entity would, in principle, be required to split the interest accreted on the contractual service margin (determined using a current rate) between profit or loss and OCI.
11. The simplest way to do this would be to require interest presented in profit or loss to be accreted at the locked in rate and to present in OCI the difference between interest accreted at the current rate and interest accreted at the locked in rate. However, applying this approach, the amounts recognised in OCI do not self-reverse to zero, as illustrated in Appendix A. This is because the contractual service margin does not true-up to an actual cash-flow. (In contrast, for the effect of recognising discount rate changes on the liability cash flows in OCI, the measurement of the liability will equal the actual cash paid at the time the liability is settled and, hence, the effects of changes in discount rates presented in OCI self-reverse by that time.) Thus, if interest accreted on the contractual service margin at a current rate were to be split between profit or loss and OCI, the IASB would need to consider if the amount recognised in OCI should be recycled to profit or loss when the insurance liability is settled. The staff note that there could be other methods of dividing interest expense between profit or loss and OCI that could result in the amounts in OCI self-reversing, however those methods would add a different complexity.
12. Alternatively, the IASB could decide to require entities to present interest accreted on the contractual service margin at the current rate in profit or loss (rather than splitting the interest between OCI and profit or loss). Presenting interest accretion at a current rate avoids the problems associated with recognising amounts in OCI that do not reverse and is simpler to apply because it avoid the tracking of discount rates. However, this approach would decrease the understandability of

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<sup>1</sup> At its March 2014 meeting the IASB tentatively decided that an entity chooses as its accounting policy to present either in profit or loss or in OCI the effects of changes in the discount rate on the insurance liability.

the split of the interest expense between OCI and profit or loss because of the inconsistent treatment of discount rate changes for the cash flows and the contractual service margin.<sup>2</sup>

### *Feedback on the 2013 ED*

13. The 2013 ED did not specifically ask for feedback on the rate used to accrete interest on the contractual service margin. However, some respondents disagreed that the rate used for interest accretion should be locked-in at inception for the same reasons noted in the feedback on the 2010 ED (described in paragraph 8). Additionally, some constituents (especially some field test participants) thought that tracking the locked-in rates would be too burdensome, because doing so would require systems and processes to track discount rates from contract inception to completion which, for some life contracts, could be up to 60 years. Concern about tracking locked-in discount rates was not identified in the feedback to the 2010 ED. With respect to the 2013 ED, that concern was generally expressed by those that also objected to the proposal to use OCI to present changes in the discount rate, which also requires the tracking of locked-in rates. Such respondents stated that they would prefer using current interest rates for some or all insurance contracts.
14. Nonetheless, some respondents to the 2013 ED agreed with the proposals to use the locked-in interest rate because they believe that:
  - (a) a locked-in rate is conceptually correct – for the reasons described in paragraph 9(a).
  - (b) a locked-in rate would avoid volatility in operating profit that is a characteristic of investment activity. Those respondents also believed that using a current rate would cause changes that would be difficult to explain to investors because changes in discount rates could cause

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<sup>2</sup> The staff note that some believe that the effect of changes in discount rates on the risk adjustment should, in concept, also be split between profit or loss and OCI. However, many think that the effect of discounting as an integral component of the risk adjustment, because the risk adjustment is a present value measure of the dispersion of cash flows. The staff do not think it is feasible to ask entities to identify the effect of change in discount rate on the risk adjustment given the different techniques that are available for measuring the risk adjustment. In addition, separating the discount rate effect on the risk adjustment would negate the benefit of the risk adjustment being explicitly measured. Therefore the staff do not propose splitting the risk adjustment in this way.

changes in the underwriting result from period to period even if there was no change in the expected cash flows.

- (c) using current interest rates for interest accretion would be more difficult when using OCI to present the effect of changes in discount rates as described in paragraph 11.

#### *Conclusions for interest accretion*

15. The staff remain persuaded by the arguments in paragraph 9 and, therefore, continue to believe that a locked-in rate is the conceptually correct rate to use. In addition, the staff believe that a locked-in rate for the accretion of interest would result in more useful information because it retains a clean separation of underwriting and investment results as well as causes less complexity overall than using a current rate. Accordingly, the staff recommend a rate locked-in at the inception of the contract for the accretion of interest on the contractual service margin.
16. The staff note that although using the additional complexity of using locked-in rates arises only when the entity's accounting policy is to recognise the effect of changes in discount rates in profit or loss, the staff think that entities should not be given a choice over which rate to use because doing so would create differences in measurement of the insurance contract.

### ***Unlocking the Contractual Service Margin***

#### *Rationale for the 2013 ED proposals*

17. After initial recognition, the entity may need to change its estimate of the present value of expected cash flows because of:
  - (a) changes in the expected timing of the payment of cash flows;
  - (b) changes in the expected amounts to be paid; or
  - (c) the effect of changes in the discount rate.
18. In the 2013 ED, the IASB proposed that the contractual service margin would be adjusted for changes in the present value of expected cash flows related to changes in expected timing and expected amounts to be paid. However, the IASB

proposed that the effect of the changes in the discount rate on the insurance liability should not be offset in the contractual service margin. This was to avoid accounting mismatches that would otherwise arise between those changes and the equivalent changes in the return on the assets held by the entity, and to avoid recognising investment gains or losses as part of the underwriting activity. The effect of changes in discount rates on the insurance contract together with the return on the investment form part of the investment result (rather than underwriting result); therefore, those amounts are measured in the same way and presented together in the statement of comprehensive income. Consequently, the 2013 ED proposed that:

- (a) the present value of cash flows that unlock the contractual service margin should be calculated using the interest rate at inception; and
- (b) the effects of changes in discount rates on the insurance contract liability would be presented separately (in OCI).

#### *Feedback on 2013 ED*

19. The 2013 ED did not seek specific input on which rate should be used to discount the cash flows that unlock the contractual service margin, and only a few respondents commented on this issue. Of those respondents, some think that the proposals were not clear and ask for a clarification. Most disagreed that an entity should use the locked-in rate to determine the present value of cash flows that is offset against the contractual service margin for the following reasons:

- (a) *Complexity.* As with interest accretion (see paragraph 13), many constituents believed that the costs of tracking the locked-in discount rate when that information is not needed to determine amounts to be recognised in OCI would not be justified. Those constituents disagreed that entities should be required to use OCI for presenting the effects of the discount rate changes.
- (b) *Meaning.* Some believed that using the current rate would better reflect the change in economic cost. Those constituents, including some users of financial statements, would prefer to see both the cash flow and discount rate effects of a change in estimates adjust the contractual

service margin, rather than to see the disaggregated information about the cash flow (or underwriting) effect in contractual service margin and the effect of discount rate changes (investment effect) in profit or loss or OCI. To illustrate that point, consider a change in mortality assumptions resulting in the delay or acceleration of a payment of claims in a contract for which there has also been a change in discount rate since inception of the contract. Some users of financial statements would prefer to see the combined effect of change in estimate caused by the change in mortality assumptions unlock the contractual service margin, rather than to see the effect due to the change in timing of payment (which is an underwriting effect) separately from the effect due to the change in discount rate (which is an investing effect) as proposed in the 2013 ED. The staff note that the split between underwriting and investment would arise in line items in the statement of comprehensive income even if an entity chose as its accounting policy to present the effect of changes in discount rate in profit or loss.

### *Conclusions for unlocking*

20. In the staff's view, the separation between underwriting and investment results is a core benefit of the IASB's model (as explained in paragraph 4 and illustrated in Appendix A). Furthermore, regardless of whether the entity presents the effect of discount rate changes in profit or loss or OCI, using locked-in rates for determining the present value of cash flows to unlock the contractual service margin better separates the underwriting and investment results by ensuring that gains and losses are recognised in the appropriate subtotal. In contrast, if an entity were to use current rates instead of locked-in rates, some changes in discount rate (and thus changes that ought to be treated as investment result) would be reported in the underwriting result through the release of contractual service margin. Consequently, the timing and recognition of some investment gains or losses would depend on the interest rate at the date of the change in the estimate of the expected cash flows. Furthermore the investment result reported over the life of the contract would not appropriately reflect the return on the investment activity and there would be decreased comparability of the results reported by entities that issue insurance contracts. Accordingly, the staff believe that, in concept, an entity



should use locked-in rates to calculate the present value of changes in cash flows that unlock the contractual service margin.

21. In addition, when an entity unlocks the contractual service margin for the present value of cash flows calculated using the current rate, additional complexity arises because the cumulative OCI under an OCI accounting policy would be more difficult to explain and calculate:
- (a) The cumulative OCI would not be the effect of changes in the discount rate since inception but rather the effect of changes in the discount rate since inception date for cash flows that are not changed since inception and the date the entity last changed the expected cash flows.
  - (b) To calculate the amount of the cumulative OCI, the entity would need to track the discount rates locked at the date entity changed the cash flows, not only at inception of the contract.<sup>3</sup>

### Staff recommendation

22. For both accretion of interest and unlocking the contractual service margin, the staff conclude that the locked-in rate should be used, because it would separate changes between the underwriting and operating result in a clear way and, therefore, would result in gains and losses recognised consistently with other non-insurance contracts (as discussed in paragraphs 9 and 20). In contrast, the current rate would result in recognition of investment gains or losses together with the underwriting (rather than investment) activity.
23. In the staff's view, the arguments about complexity are finely balanced:
- (a) The locked-in rate would not introduce additional complexity for those that track locked-in discount rates for presentation purposes. However it would impose an additional burden on those that decide to present changes in the discount rates in profit or loss (as discussed in paragraph 13).

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<sup>3</sup> The staff note that the whole analysis in this section equally applies to the effect of changes in discount rate on the risk adjustment. However, staff do not believe that such separation would be feasible as described in footnote 2.

(b) The current rate would be simpler for those that decide to present changes in the discount rate in profit or loss. However, if an entity presents the effect of changes in discount rate in OCI, then, as discussed in paragraphs 10-12, the IASB would need to specify how amounts would reverse from OCI. Alternatively, the IASB could require that the effect of interest rate change on the contractual service margin be presented in profit or loss, which would decrease the understandability of changes recognised in the OCI (as discussed in paragraph 12).

24. The staff note that at its March 2014 meeting the IASB tentatively decided that an entity should choose as its accounting policy whether to present the effect of changes in the discount rates in profit or loss or OCI. One of the main reasons for that decision was constituents' feedback about the complexity of tracking the discount rate at inception of the contract. Accordingly, some constituents proposed that the rate used for the accretion of interest and unlocking should depend on the entity's accounting policy for presentation of the discount rate changes. However, as described in paragraphs 4 and 5, using different rates would affect the measurement of the insurance contract. The staff do not think that this proposal is viable, because it would mean that entities would be permitted differences in measurement based on *presentation* choices. In the staff's view this would decrease significantly comparability between insurance contracts.

#### Question

Does the Board agree with the staff recommendation that, for contracts without participating features, an entity should use the **locked-in** rate at inception of the contract for accreting interest on the contractual service margin and for calculating the change in the present value of expected cash flows that offsets that margin?

If the Board disagrees with the staff recommendation and decides that an entity should use a **current** rate for accreting interest on the contractual service margin and calculating the change in the present value of expected cash flows that offsets that margin, does the Board agree that an entity should divide the interest accreted on the contractual service margin (determined using a current rate) between profit or loss and OCI?

## Appendix A: Examples illustrating the effect of using locked in, rather than current, rates for accreting interest and unlocking the contractual service margin

### **Example 1: Interest accretion**

- A1. Example 1 illustrates<sup>4</sup> the difference in the financial statements when an entity uses:
- (a) the locked-in rate to accrete interest on the contractual service margin; compared to
  - (b) the current rate to accrete interest on the contractual service margin.
- A2. Example 1 is based on the following assumptions:
- (a) The contract provides coverage for insurance risk over 5 years.
  - (b) The policyholder pays a premium of CU1,200 at the start of the coverage period.
  - (c) The insurer expects to pay a claim of CU893 at the end of the coverage period.
  - (d) The liability discount rate at inception equals 5%. It changes to 2% at the end of year 2.
  - (e) As a consequence, the contractual service margin equals CU500 at inception (present value of expected premiums of CU1,200 – present value of expected claims of CU700). The contractual service margin is allocated on the basis of the passage of time.
  - (f) The risk adjustment equals zero for simplification.

### **Balance sheet**

- A3. The tables below illustrate the reconciliation of the contractual service margin from the opening to closing balance at the end of each period of the coverage period calculated using (i) locked-in and (ii) current rates. The staff note that the

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<sup>4</sup>This Example does not illustrate other features of the proposal.

calculation of the contractual service margin does not affect the amount of the fulfilment cash flows which are always measured using the current rate; consequently the difference between the contractual service margin at the end of each period would result in the equivalent difference between the insurance liabilities. (Please note that there might be some minor errors due to rounding.)

<b>Locked-in rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	331	232	122	500
Interest accreted <sup>5</sup>	25	21	17	12	6	80
Release to the p&l <sup>6</sup>	-105	-110	-116	-122	-128	-581
Closing balance	420	331	232	122	0	0

<b>Current rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	321	219	111	500
Interest accreted <sup>7</sup>	25	8	6	4	2	46
Release to the p&l	-105	-107	-109	-111	-114	-547
Closing balance	420	321	219	111	0	0

<b>Difference between closing balance at locked-in rate and closing balance at current rate</b>						
	0	-9	-13	-10	0	0

### *Statement of comprehensive income*

A4. The tables below illustrate the amounts recognised in the statement of comprehensive income using locked-in and current rate for the interest accretion.

The staff note that as the amounts of (i) interest income and (ii) part of the interest expense related to the cash flows is irrelevant for this exercise, those amounts were omitted.

<sup>5</sup> Interest accreted on the margin equals locked-in rate × opening balance of the contractual service margin. For example in Year 1 the interest equals 25 calculated as  $500 \times 5\%$ .

<sup>6</sup> Release to the P&L equals the opening balance with the interest accretion divided by the remaining numbers of the coverage periods. For example in Year 1 the release to the P&L equals 105 calculated as  $(500+25)/5$ .

<sup>7</sup> Interest accreted on the margin equals current rate × opening balance of the contractual service margin.

<b>Locked-in rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Underwriting result (release of CSM)	105	110	116	122	128	581
Investment result (interest expense)	-25	-21	-17	-12	-6	-80
<b>Total comprehensive income</b>	<b>80</b>	<b>89</b>	<b>99</b>	<b>110</b>	<b>122</b>	<b>500</b>

<b>Current rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Underwriting result (release of CSM)	105	107	109	111	114	547
Investment result (interest expense)	-25	-8	-6	-4	-2	-46
<b>Total comprehensive income</b>	<b>80</b>	<b>99</b>	<b>103</b>	<b>107</b>	<b>111</b>	<b>500</b>

<b>Comparison</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Difference in underwriting result	0	3	7	10	14	34
Difference in investment result	0	-13	-10	-7	-4	-34
<b>Difference in total comprehensive income</b>	<b>0</b>	<b>-9</b>	<b>-4</b>	<b>3</b>	<b>10</b>	<b>0</b>

A5. As illustrated above, accreting interest using a locked-in rate, rather than a current rate does not affect the cumulative amount of total comprehensive income recognised. However, in addition to the effects on the measurement of the insurance contract liability (as explained in paragraph A3), it affects:

- (a) the underwriting and investment result in each reporting period and over the life of the contract; and
- (b) the total comprehensive income recognised in each period.

*Example 1A: Illustrates complexity of OCI separation when accreting interest using current rate (see paragraphs 10-12)*

- A6. Furthermore, the staff note that for entities that choose OCI for the presentation of discount rate changes, a requirement to treat changes in discount rate resulted from cash flows and contractual service margin consistently could add significant complexity. The main issue is related to the fact that the amount of the discount rate on the contractual service margin might not automatically reverse in a similar way as those do for the cash flows.
- A7. The table below illustrates the split of the effect of the discount rate changes on the contractual service margin between profit or loss and OCI. Example 1A illustrates the assumptions and amounts in the Example 1. Please note that the amount of accumulated OCI does not automatically reverse and equals CU34 at the end of year 5.

<b>Profit or loss statement</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Interest expense <sup>8</sup>	-25	-21	-17	-12	-6	-80
Changes in OCI <sup>9</sup>	0	13	10	7	4	34
<b>Total Comprehensive Income<sup>10</sup></b>	-25	-8	-6	-4	-2	-46

<b>Accumulated OCI</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	0	0	13	23	30	0
Changes in OCI	0	13	10	7	4	34
<b>Closing balance</b>	0	13	23	30	34	34

<sup>8</sup> Interest expense in P&L is calculated using locked-in rate as in Example 1.

<sup>9</sup> Difference between the interest expense calculated using current and locked-in rate.

<sup>10</sup> Interest expense in total comprehensive income is calculated using locked-in rate as in Example 1.

**Example 2: Unlocking the Contractual Service Margin**

A8. The basic assumptions in Example 2 are the same as for the Example 1. However, at the end of year 3, the entity revises its expectations about the expected cash outflows so that the entity expects to pay CU1,100, rather than the CU893 that was expected at inception. The present value of the difference of CU207 adjusts the contractual service margin. That present value would be:

- (a) CU188 if the change in cash flows is discounted using locked-in rate of 5%;
- (b) CU199 if the change in cash flows is discounted using current rate of 2%.

**Balance sheet**

A9. The tables below illustrate the reconciliation of the contractual service margin from the opening to closing balance at the end of each period of the coverage period calculated using (i) locked-in; and (ii) current rates. The staff note that the calculation of the contractual service margin does not affect the amount of the fulfilment cash flows which are always measured using the current rate; consequently the difference between the contractual service margin at the end of each period would result in the equivalent difference between the insurance liabilities.

<b>Locked-in rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	331	44	23	500
Interest accreted	25	21	17	2	1	66
Release to P&L	-105	-110	-116	-23	-24	-378
Change in present value of expected cash flows (PVCFs)	0	0	-188	0	0	-188
Closing balance	420	331	44	23	0	0

<b>Current rate</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	331	33	17	500
Interest accreted	25	21	17	2	1	65
Release to P&L	-105	-110	-116	-17	-18	-366
Change in PVCFs	0	0	-199	0	0	-199
Closing balance	420	331	33	17	0	0

<b>Difference between closing balance at locked-in rate and closing balance at current rate</b>	0	0	-11	-6	0	0
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A10. As illustrated above, the rate used to calculate the present value of cash flows that unlocks the contractual service margin affects the balance of the insurance contract liability at the end of each period after the change (in Example 2– year 3).

*Statement of comprehensive income*

A11. The tables below illustrate the amounts recognised in the statement of comprehensive income using locked-in and current rate for calculating present value of expected cash flows that unlock the margin.

**Locked in rate**

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Underwriting result (release of contractual service margin)	105	110	116	23	24	378
Investment result (interest expense)	-25	-21	-28	-2	-1	-77
<b>Total comprehensive income</b>	<b>80</b>	<b>89</b>	<b>88</b>	<b>21</b>	<b>23</b>	<b>301</b>

**Current rate**

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Underwriting result (release of contractual service margin)	105	110	116	17	18	366
Investment result (interest expense)	-25	-21	-17	-2	-1	-65
<b>Total comprehensive income</b>	<b>80</b>	<b>89</b>	<b>99</b>	<b>16</b>	<b>17</b>	<b>301</b>

**Comparison**

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Underwriting result	0	0	0	6	6	12



Investment result	0	0	-11	-1	0	-12
Total comprehensive income	0	0	-11	5	6	0

A12. As illustrated in the tables above (and consistently with the interest accretion), the choice of locked-in or current rates does not affect the accumulated total comprehensive income. However, in addition to the effects on the measurement of the insurance contract liability (as explained in paragraph A10), it affects:

- (a) the underwriting and investment result in each reporting period and over the life of the contract; and
- (b) the total comprehensive income at the end of each period.

A13. When the entity unlocks the margin for the present value of cash flows calculated using locked-in rates, the discount rate effect on changes in cash flows are recognised in the investment result. Therefore, the underwriting result is not affected by the discount rate changes but only by the change in expected cash flows since inception. When the present value of cash flows that unlocks the margin is measured using the current rate, the discount rate change on those cash flows is reported in the underwriting result.

## Appendix B: Relevant paragraphs from the 2013 ED and Basis for Conclusions

### Subsequent measurement

- 29 (...)
- 30 The remaining amount of the contractual service margin at the end of the reporting period is the carrying amount at the start of the reporting period:
- (a) plus the interest accreted on the carrying amount of the contractual service margin during the reporting period to reflect the time value of money (the interest accreted is calculated using the discount rates specified in paragraph 25 that applied when the contract was initially recognised);
  - (b) minus the amount recognised in accordance with paragraph 32 for services that were provided in the period;
  - (c) plus a favourable difference between the current and previous estimates of the present value of future cash flows, if those future cash flows relate to future coverage and other future services (see paragraph B68);
  - (d) minus an unfavourable change in the future cash flows:
    - (i) if the change arises from a difference between the current and previous estimate of the present value of future cash flows that relate to future coverage and other future services; and
    - (ii) to the extent that the contractual service margin is sufficient to absorb an unfavourable change. The contractual service margin shall not be negative.
- (...)

### Basis for Conclusions

#### Adjusting the contractual service margin (paragraphs 30(c)–(d) and B68)

- (...)
- BC32 Consistently with its view of the contractual service margin as the profit that is recognised as the entity provides coverage and other services, the IASB proposes that:
- (...)
- (d) adjustments to the contractual service margin are recognised prospectively using the latest estimates of the future cash flows. In other words, any changes would be recognised in profit or loss as the contractual service margin is recognised over the coverage period that remains after the adjustments are made.
  - (e) the effects of changes in discount rates and in the risk adjustment do not affect the amount of unearned profit because those changes unwind over time. Accordingly, the contractual service margin would not be adjusted to reflect the effects of changes in the discount rate or in the risk adjustment.

### Consequences

#### *Consistency with revenue recognition principles*

- BC33 When an entity adjusts the contractual service margin for changes in estimates of cash flows relating to future coverage or other future services, there is a transfer between the components of the insurance contract liability, with no change in the total carrying amount of the liability. The total insurance contract liability is remeasured for changes in estimates of expected cash flows only if there is an unfavourable change relating to future coverage or other future services that exceeds the remaining balance of the contractual service margin, ie if the contract has become onerous. This means that the

effect of offsetting changes in estimates against the contractual service margin is that the measurement of those liabilities as a whole does not change as a result of changes in expected claims and expenses that would lower expected profit. That is consistent with the measurement of contract liabilities under the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*, which also does not remeasure performance obligations based on changes in cash outflows.

- BC34 The IASB's 2007 Discussion Paper proposed an explicit service margin that was remeasured. However, those proposals differed from the proposals in this Exposure Draft and the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*. The 2007 Discussion Paper proposed that the service margin would be measured as the estimated margin that market participants would require and that it would be remeasured every period. In contrast, the contractual service margin in this Exposure Draft is a contractual margin implied by the premiums that the entity charged. That contractual service margin is the margin that produces no profit or loss at inception and is remeasured only for changes in estimates of cash flows relating to future coverage or other future services. Accordingly, the contractual service margin proposed in this Exposure Draft reflects the price that the entity charged to provide the remaining services. As a result, the measurement of the liability is consistent with the measurement of contract positions applying the 2011 Exposure Draft *Revenue from Contracts with Customers*, which also reflects the price that the entity charged to provide services.

### **Accretion of interest (paragraph 30(a))**

- BCA71 This Exposure Draft proposes that an entity should accrete interest on the contractual service margin. In the IASB's view:
- (a) at initial recognition, the contractual service margin can be viewed as an allocation of part of the transaction price, which comprises the consideration paid to, or payable by, the policyholder. Accreting interest on the contractual service margin is consistent with the proposal in the 2011 Exposure Draft *Revenue from Contracts with Customers*, which would require an entity to adjust the promised consideration to reflect the time value of money if the contract has a significant financing component. As a result of that adjustment, the transaction price would reflect the amount that the customer would pay in cash for the promised good or service at the time that they receive the good or service. Consequently, an entity would recognise revenue at an amount that corresponds to the cash selling price of the good or service, with the effects of the financing presented separately from revenue (as interest expense or interest income).
  - (b) the contractual service margin is one part of an overall measure of the insurance contract, and every other component of that measure reflects the time value of money, leading to subsequent accretion of interest. The accretion of interest on the contractual service margin is consistent with that fact.
- BCA72 Because the contractual service margin is measured at contract inception, the IASB proposes that the interest rate used to accrete interest on the margin would be locked-in at contract inception and not adjusted subsequently. Furthermore, the discount rate applied to cash flows that are included in the measurement of the liability should be consistent with the time value of money that is reflected in the other components of the liability. Thus, the accretion of interest represents the fact that the entity would have charged a different amount at contract inception if it had expected to recognise the profit represented by the contractual service margin at a different time.
- BCA73 Some believe that interest should not be accreted on the contractual service margin on the grounds of simplicity and because they view the contractual service margin as being a deferred credit rather than a representation of a component of an obligation. However, the IASB did not find these views persuasive.