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STAFF PAPER

18-19 March 2014

REG IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Unlocking the contractual service margin		
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Objective

1. Under the general approach proposed in the IASB's 2013 Exposure Draft *Insurance Contracts* (IASB ED), the measurement of an insurance contract includes a contractual service margin. The contractual service margin is measured at inception as the difference between (a) the present value of the expected cash flows plus a risk adjustment and (b) the present value of expected premiums.

2. This paper discusses whether to confirm the proposals in the ED to adjust (ie 'unlock') the margin for differences between current and previous estimates of the present value of cash flows relating to future coverage or other services after inception.

3. This paper is structured as follows:

   (a) staff recommendation (in paragraph 6-7);

   (b) background of the unlocking proposals in the ED (in paragraphs 8-14), including a simplified example to explain the differences between unlocking and locking in the margin (in Appendix A) and the relevant paragraphs from the Basis for Conclusions explaining the rationale behind the IASB's decision to unlock the margin (in Appendix B);

   (c) a summary of the feedback received on the ED proposals (in paragraphs 15-18); and

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(d) staff analysis and recommendations (in paragraphs 19-32).

4. Assuming that the IASB agrees with the staff recommendation in this agenda paper, Agenda Papers 2B and 2C consider follow-up issues. Agenda Paper 2B considers whether favourable changes in estimates of the present value of cash flows should be first recognised in profit or loss to the extent they represent the reversal of losses previously recognised in profit or loss. Agenda Paper 2C considers whether the contractual service margin should be unlocked for changes in the risk adjustment.

5. This paper and Agenda Papers 2B and 2C do not discuss:

(a) other aspects of how the margin is accounted for. For example, the unit of account for the margin, the allocation or the amount recognised in profit or loss in the period, and the interaction between the interest rate effects and the margin (eg accretion); and

(b) whether and how to account for features specifically arising from participating contracts and reinsurance contracts. The term ‘participating contracts’ refers to insurance contracts that provide an investment return to the policyholder that is affected by the performance of underlying items (eg assets).

Recommendations

6. The staff recommend that the IASB confirm the proposals in the IASB ED that after inception:

(a) differences between the current and previous estimates of the present value of cash flows related to future coverage and other future services should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of cash flows that do not relate to future coverage and other future services should be recognised immediately in profit or loss.

7. After the IASB has considered the treatment of the contractual service margin for participating contracts, the staff will consider whether the tentative decisions reached for non-participating contracts need to be revisited, and vice versa.

Background

The margin at inception

8. At inception, the contractual service margin eliminates any gains by calibrating the measurement of the insurance contract to the transaction price. No gains are recognised in profit or loss, because the entity has not yet satisfied any of its performance obligations. Hence, the IASB views the margin as profit for the contract that is to be earned as the entity satisfies the performance obligation (eg by providing insurance coverage and other services). This is consistent with the IASB's decisions in the *Revenue from Contracts with Customers* project. Under revenue recognition, the entity allocates the transaction price for a contract to the performance obligations in the contract and recognises the transaction price in profit or loss when it has satisfied those performance obligations. At inception, the entity has yet to perform and hence no gain should be recognised.

9. The IASB's proposal to recognise any losses at inception immediately in profit or loss is also consistent with the recognition of losses on onerous revenue contract under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

What is unlocking?

10. Subsequent to inception, where should changes in estimates be recognised? Those changes could adjust (ie unlock) the margin or be recognised in profit or loss (referred to as 'locking in the margin').

11. The 2010 Exposure Draft *Insurance Contracts* proposed that the contractual service margin that is recognised at contract inception should not be adjusted subsequently to reflect the effects of changes in the estimates of the fulfilment cash flows. In the feedback on the IASB's 2010 Exposure Draft, many stated that the measurement of the insurance contract liability would provide a more faithful representation of the

unearned profit that would be recognised over the remaining coverage period if the margin was unlocked to reflect changes in estimates made after inception. Those with this view argued that it would be inconsistent to prohibit the recognition of gains at initial recognition, but then to require the subsequent recognition of gains on the basis of changes in estimates made immediately after initial recognition.

12. The IASB was persuaded by this view. Consequently, the IASB's 2013 Exposure Draft *Insurance Contracts* (ED) proposed to unlock the margin for differences between the present value of current and previous estimates of cash flows relating to future coverage and other services. That proposal is consistent with the view that the unearned profit, represented by the contractual service margin, is earned when the entity provides services under the contract.

13. To implement unlocking, the IASB ED proposed that the contractual service margin would:

    (a) be increased as a result of favourable changes in the current and previous estimates of the present value of cash flows relating to future coverage and other services. Favourable changes in estimates of the present value of cash flows, whether lower than expected cash outflows or higher than expected cash inflows, increase the profit that the entity will recognise from the contract up to a maximum that is set by the amount of total expected cash inflows from the contract.

    (b) be decreased as a result of unfavourable changes in the current and previous estimates of the present value of cash flows relating to future coverage and other services, but the margin cannot be negative. This means that once the contractual service margin has been exhausted, overall losses arising from the contract would be recognised immediately in profit or loss. This is because any excess of fulfilment cash flows over the contractual service margin would mean that the contract is expected to be onerous (ie loss-making), rather than profit-making, in the future.

    (c) would not be adjusted for changes in the current and previous estimates of the present value of cash flows relating to past/current coverage and other

services. These changes in estimates would be recognised in profit or loss in the period when the change is known.

14. Appendix A provides a simplified example to explain the differences between unlocking and locking in the margin. Appendix B provides relevant paragraphs from the Basis for Conclusions explaining the rationale behind the IASB's decision to unlock the contractual service margin.

Summary of feedback on IASB ED proposals

15. Most constituents supported the proposals in the IASB ED to adjust the margin for both favourable and unfavourable changes in the current and previous estimates of the present value of cash flows relating to future coverage and other services, so long as the margin is not negative. Their reasons are discussed in paragraph 23. A few did not support unlocking for the reasons discussed in paragraph 23. Respondents noted that both a locked-in and unlocked margin may result in an increase in complexity.

16. Many agreed that the distinction between changes in estimates of the present value of cash flows relating to past or current coverage should be recognised immediately in profit or loss; and changes in estimates of the present value of cash flows relating to future coverage should adjust the margin to be recognised in future periods. Their reasons are discussed in paragraph 29. A few believe that all changes in estimates should adjust the margin, regardless of whether those changes relate to the past or current/future provision of coverage and other services. Their reasons are discussed in paragraph 29.

Complexity

17. Respondents raised the following related issues on the complexity of unlocking as proposed in the IASB ED:

    (a) Some smaller preparers, or preparers in emerging economies, were concerned about the tracking that might be required when the margin is unlocked. However, it appears that many who expressed this concern believed that there was a retrospective element to unlocking, rather than the fully prospective approach that the ED proposes.

(b) Some were concerned about the level of aggregation for implementing the proposed requirements for the margin, including unlocking. These preparers are concerned that the level of aggregation is lower than they currently use for measurement, because lower levels of aggregation would be associated with higher operational costs. Central to their concerns is the appropriate unit of account and definition of a ‘portfolio’ rather than the proposal to unlock the margin. The staff will consider this issue in a future agenda paper.

18. In addition, while there is an increase in complexity in unlocking to determine whether a change in estimate relates to current/past coverage or future coverage, some noted that this proposal is operational. This is because their existing practice already requires them to analyse the effects of assumption changes. Consequently, they think it is feasible to determine whether the effects of those changes in assumptions relate to the provision of services in the current/past periods or to future periods.

Analysis

19. This section discusses the central question of whether to unlock the margin. The arguments on whether to lock in or unlock the margin are in paragraphs 22-27.

20. When the margin is unlocked, the feedback from the IASB ED indicates broad support for the proposal:

(a) to **not** unlock the margin for changes in discount rates (ie the margin is unlocked for changes in estimates in cash flows);

(b) to increase the margin as a result of favourable changes (discussed in paragraph 13(a)); and

(c) to decrease the margin as a result of unfavourable changes until the margin is zero. Subsequent unfavourable changes would be recognised immediately in profit or loss (discussed in 13(b)).

Consequently, the staff do not intend to discuss these proposals further.

21. The feedback indicates mixed views on whether **all** changes in estimates of the present value of cash flows, or **only** changes in estimates of the present value of cash

flows relating to future coverage or other services, should adjust the margin. This issue is discussed in paragraphs 28-30.

Whether to unlock?

22. This section considers the arguments for and against unlocking the margin.

23. Arguments for recognising changes in estimates in cash flows in profit or loss (ie locking in the margin) are that:

    (a) Changes in circumstances should be reflected in the primary financial statements as soon as the entity is aware of those changes, because it provides better information.

        (i) Some think that a reduction or increase in the cash flows that fulfil the contract should lead to a corresponding decrease or increase in the liability recognised on the balance sheet. They believe that doing so is consistent with the IASB's objective for a current measurement of the insurance liability. They view the effect of unlocking the margin on the liability recognised on the balance sheet as being counterintuitive. So long as the margin is positive, unlocking means that changes in estimates result in **no** change in the liability reported on the balance sheet (see paragraph A6 in the example).

        (ii) Others think that recognising changes in estimates on cash flows immediately in profit or loss would provide transparent, more easily explained and relevant information. They believe that a change in estimates is an economic event that is better signalled by recognising such a change in profit or loss.

        (iii) An insurance contract is a blend of both a service contract and a financial instrument. Some see the predominant characteristics of an insurance contract as closer to a financial instrument. They note that under IFRS 9 *Financial Instruments* changes in cash flows of a financial instrument are recognised immediately in profit or loss as a gain or loss and in an increase or decrease in the amount recognised on the balance sheet. This occurs for both instruments measured at fair value and amortised cost (eg

changes in the prepayments of a debt instrument result in gains or losses in profit or loss and changes in the amount recognised in the balance sheet).

(b) Some think the margin on Day one primarily consists of the excess of premiums necessary to pay for indirect expenses that the IASB ED proposes should be recognised when incurred, and not as part of the fulfilment cash flows. Consequently, the amount of the margin recognised in each period should represent the margin required to cover indirect expenses and other expenses that are not recognised as part of the fulfilment cash flows. They are concerned that, as a result of unlocking, there might be insufficient contractual service margin to match against expenses in some periods. They note that unlocking in this instance creates a difference from the proposals in the Revenue Recognition project, because those proposals would require revenue and the related expenses to be recognised in the period when the entity performs the performance obligations.

(c) Some believe that the margin represents an obligation to provide services that is measured at initial recognition as the difference between (a) the present value of the expected cash flows plus a risk adjustment and (b) the present value of expected premiums. That obligation is separate from the obligation to make the payments required to fulfil the contract. Changes in the estimates of the payments that are required to fulfil the contract do not increase or decrease the obligation to provide services and consequently do not adjust the measurement of that obligation.

(d) Some think that the mechanics of a locked-in margin are simpler to apply than unlocking the margin. This was discussed in paragraph 17.

24. Arguments for unlocking are that:

(a) Changes in estimates of cash flows affect the future profitability of the contract. Thus, adjusting the margin to reflect these changes would provide a more faithful representation of the remaining unearned profit in the contract after inception.

(b) It would avoid the counterintuitive effects of a locked-in margin. Immediate recognition of unfavourable changes in estimates can make contracts that are profitable overall appear to be loss-making in some years. Conversely, it can also make contracts that become loss-making overall appear to be profitable in later years.

(c) It would increase consistency between measurement at inception and subsequent measurement. At inception the recognition of gains in profit or loss are prohibited, on the basis that the estimates may be equally unreliable. To be consistent with the measurement at inception, subsequent favourable changes in estimates should also not be recognised in profit or loss because they can also be argued to be unreliable.

(d) It provides more transparent information on the effects of changes in estimates. When the margin is unlocked, the effect of unfavourable changes in estimates are recognised in the period in which the related service is provided. When the margin is locked, unfavourable changes are reported immediately and the unaltered larger margin continues to be released into future periods. Some contend that the effects of a locked-in margin are akin to ‘big bath’ provisions, which is misleading because a locked-in margin does not highlight that profitability has decreased over future periods. Hence, unlocking allows users to analyse better the effects of changes in estimates, because users would typically value lower profitability over several periods differently than for a one-time loss.

(e) It would reduce the complexity of a locked-in model when applying the proposals retrospectively and in determining insurance contract revenue, by reducing the need for guidance when contracts are modified in some circumstances and removing the need for another onerous contract test.

Staff recommendation

25. The staff note that either locking in or unlocking the margin introduces operational complexity. Consequently, the decision on whether the margin should be locked in or unlocked would need to be based on the benefits of doing so.

26. The staff recommend unlocking the margin, for the reasons discussed in paragraph 23. In reaching this recommendation, the staff placed greatest weight on the fact that unlocking would increase the consistency between the margin on Day one and day Two.

27. The staff noted that the main criticism of unlocking, on the transparency of the effects of recognising changes in estimates, discussed in paragraph 23(a), can be partially addressed by providing disclosures, particularly the reconciliation of contract balances. Many users have stated that such a disclosure would be important in understanding the effect of changes in estimates that were offset in the margin.

Unlock for only changes relating to future coverage

28. The proposals for unlocking the ED are consistent with the view of the contractual service margin as being unearned profit that is earned when the entity provides services under the contract. Applications of that view leads to the following conclusions for how changes in estimates would be treated:

    (a) Claims are sometimes incurred in one period but settled in a later period (eg incurred but not reported). Changes in estimates of claims incurred in a past reporting period would not adjust the margin, because these claims relate to past coverage. Such changes would be recognised immediately in profit or loss.

    (b) Expenses for the current and future periods could be higher than expected because of an increase in inflation. The unfavourable change for the expenses in the current period would be reflected in profit or loss, because it relates to coverage provided. The unfavourable change in the expected expenses for the future periods would adjust the margin, because it relates to future coverage or other services.

    (c) There is a net effect due to a delay in the timing of when claims (or other payments) are incurred, which would adjust the margin. For example, this would happen if fewer than expected policyholders died in the current period, and there would therefore be an increase in estimates of policyholders that may die in future periods. The net effect of that change

would adjust the margin. because it relates to an increase in the provision of coverage in future periods, because the number of contracts in-force in future periods is higher than expected.

(d) There is a net effect due to an acceleration in the timing of when claims (or other payments) are incurred, which would be recognised in profit or loss. For example, this would happen if more than expected policyholders lapse in the current period, and there would be a decrease in estimates of policyholders that may die or lapse in future periods. The net effect of that change would be recognised in profit or loss, because it relates to an increase in the provision of coverage in the current period, because the number of contracts in-force that are derecognised in the current period is higher than expected. (In addition, under the IASB ED proposals, the entity would need to recognise the margin in profit or loss that relates to the contracts that have been derecognised.)

(e) There are changes in assumptions relating to future periods for contracts that are in-force on the reporting date. For example, there could be a change in the premiums expected to be collected in future periods for the contracts that are in-force on the reporting date. Those changes relate to the provision of future coverage or other services and hence, the effect of that change would adjust the margin.

29. However as noted in paragraph 16, a few suggest that **all** changes in estimates of the present value of cash flows should adjust the margin as follows:

(a) A few think that it is arbitrary to split the changes of estimates between the current/past and future provision of coverage.

(b) It is simpler to do so than determining whether a change in estimates relates to the current/past and future provision of coverage. In other words, it avoids the complexity required for entities to apply judgement to determine whether differences in estimates of cash flows relate to past/current or future coverage.

30. In contrast, arguments for unlocking the margin only for changes in the present value of cash flows relating to future coverage or other services are that:

(a) It is consistent with the rationale for unlocking as described in paragraph 24(a), which is that the margin represents unearned profit that the entity would earn by providing coverage and other services in future periods. Changes in estimates relating to current or past coverage or other services do not relate to the provision of coverage services in the future and therefore should not unlock the margin.

(b) Recognising gains and losses in profit or loss when the changes in estimates of the present value of cash flows relates to the coverage and other services provided in the past and current periods is consistent with the guidance on changes in estimates in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This is because IAS 8 distinguishes between:

(i) changes that affect the period of change only; and

(ii) changes that affect the period of change and future periods.

Thus the proposals are consistent with the application of the principles in IAS 8 as follows[1]:

(iii) similarly to changes in estimates of bad debts, changes in claims that have been incurred are recognised in the current period's profit or loss; while

(iv) the effects of changes in estimates for future periods are to be recognised in those future periods.

Staff recommendation

31. The staff recommend adjusting the margin for only changes in estimates of cash flows relating to coverage and other services to be provided in future periods, for the

[1] IAS 8 provides the following guidance on distinguishing between changes that affect the period of change and changes that affect future periods:

"A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods."

reasons discussed in paragraph 30. The staff believe that the benefits of determining whether changes in the present value of cash flows relate to future or past/current period outweigh the increased complexity of making that determination.

Question for the IASB

Question 1: whether to unlock the margin as proposed in the ED
Does the IASB agree to confirm the proposals in the IASB ED that after inception: (a) the margin should be adjusted for differences between the current and previous estimates of the present value of cash flows related to future coverage; in addition, other future services should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and (b) differences between the current and previous estimates of the present value of cash flows that do not relate to future coverage and other future services should be recognised immediately in profit or loss?

Next steps

32. Assuming that the IASB agrees with the staff recommendation in this agenda paper, Agenda Papers 2B and 2C consider follow-up issues. Agenda Paper 2B considers whether favourable changes in estimates of the present value of cash flows should be first recognised in profit or loss to the extent that they represent the reversal of losses previously recognised in profit or loss. Agenda Paper 2C considers whether the contractual service margin should be unlocked for changes in the risk adjustment.

Appendix 1: Simplified example to illustrate unlocking and locking in the margin

A1. The following example illustrates the differences between unlocking and locking in the contractual service margin, using simplified assumptions.

Initial estimates of future cash flows

A2. The initial estimates for a portfolio of contracts are:

(a) premiums 200 currency units (CU200[2]) per year for 5 years;

(b) expected claims CU100 per year for 5 years; and

(c) time value of money, risk, deposit component and expenses are all immaterial.

Table 1: Initial estimates—statements of comprehensive income

	Year					
	1	*2*	*3*	*4*	*5*	*Total*
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
Insurance contract revenue	200	200	200	200	200	1,000
Incurred claims	(100)	(100)	(100)	(100)	(100)	(500)
Underwriting result (Initial allocation of margin)	100	100	100	100	100	500

Change in estimates of future cash flows

A3. At the end of Year 2, the insurer revises its estimates. It estimates that claims in Years 3, 4 and 5 will increase by CU40 each year. The insurer adjusts its measurement of the present value of the fulfilment cash flows—increasing expected future outflows by CU120 (= CU40 + CU40 + CU40). Assume no changes in the number of in-force contracts per period.

[2] In this paper, currency amounts are denominated in 'currency units' (CU).

Locking in the margin—recognise change immediately in profit or loss

A4. Under the proposal to lock in the margin, changes in estimates of future cash flows should be recognised immediately in profit or loss.

Table 2: Change in estimate recognised immediately in profit or loss—statements of comprehensive income

	Year					
	1	2	3	4	5	Total
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
Insurance contract revenue	200	200	200	200	200	1,000
Incurred claims	(100)	(100)	(140)	(140)	(140)	(620)
Change in estimates	-	(120)	-	-	-	120
Unwind of change in estimates as higher claims are incurred	-	-	40	40	40	(120)
Underwriting result (Allocation of locked margin minus change estimate in Year 2)	100	(20)	100	100	100	380

A5. When the margin is locked in, the change in estimates of future cash flows would also impact the measurement of the liability on the balance sheet.

Table 3: Change in estimate reflected in the measurement of the liability—liability at end of Year 2

Liability	Original estimate *CU*	Change in estimate *CU*	Adjusted estimate *CU*
Present value of fulfillment cash flows (Years 3-5)	300	120	420
Margin (Years 3-5)	300		300
Total liability	600	-	720

Unlock the margin

A6. When the margin is unlocked, the change in estimates of future cash flows would be offset against the margin instead of being recognised immediately in profit or loss. The *total* liability remains the same.

Table 4: Change in estimate offset against margin—liability at end of Year 2

Liability	Original estimate *CU*	Change in estimate *CU*	Adjusted estimate *CU*
Present value of fulfillment cash flows (Years 3-5)	300	120	420
Margin (Years 3-5)	300	(120)	180
Total liability	600	-	600

A7. The adjusted margin of CU180 would be recognised in profit or loss prospectively, with CU60 being recognised in each of Years 3, 4 and 5 according to the proposals in the IASB ED.

Table 5: Change in estimate offset against margin—statements of comprehensive income

	Year					
	1	2	3	4	5	Total
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
Insurance contract revenue	200	200	200	200	200	1,000
Incurred claims	(100)	(100)	(140)	(140)	(140)	(620)
Underwriting margin						
(Allocation of margin, as adjusted prospectively at end of Year 2)	100	100	60	60	60	380

Appendix B: Extracts from the Basis for Conclusions of the 2013 ED

A8. The following are relevant paragraphs from the Basis for Conclusions explaining the rationale behind the IASB's decision to unlock the contractual service margin.

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

Background and rationale

BC26 The main service provided by insurance contracts is insurance coverage, but contracts may also provide asset management or other services. An entity that provides services will typically require a payment of more than the risk-adjusted expected present value of the expected cost for providing the services. Thus, the measurement of an insurance contract at inception includes a contractual service margin, which represents the margin that the entity has charged for the services it provides in addition to bearing risk. The expected margin charged for bearing risk is represented by the risk adjustment (see paragraphs BCA89–BCA104).

BC27 This Exposure Draft confirms the proposal in the 2010 Exposure Draft that the contractual service margin should be measured, at initial recognition of the contract, as the difference between the expected present value of cash inflows less the expected present value of cash outflows, after adjusting for uncertainty and any cash flows received or paid before initial recognition. Unlike the 2010 Exposure Draft, this Exposure Draft proposes that an entity should update the measurement of the contractual service margin for changes in expected cash flows relating to future coverage or other future services.

BC28 The 2010 Exposure Draft proposed that the contractual service margin that is recognised at contract inception should not be adjusted subsequently to reflect the effects of changes in the estimates of the fulfilment cash flows. The reasons underlying that view were that:

(a) changes in estimates during an accounting period are economic changes in the cost of fulfilling a portfolio of contracts in that period, even when they relate to future services. Recognising changes in estimates immediately in profit or loss would provide transparent, relevant information about changes in circumstances for insurance contracts.

(b) some believe that the contractual service margin represents an obligation to provide services that is separate from the obligation to make the payments required to fulfil the contract. Changes in the estimates of the payments that are required to fulfil the contract do not increase or decrease the obligation to provide services and consequently do not adjust the measurement of that obligation.

(c) for changes in the estimates of financial market variables, such as discount rates and equity prices, there would be accounting mismatches if the assets that back insurance liabilities were measured at fair value and the contractual service margin were adjusted for those changes.

BC29 Those reasons remain persuasive to the FASB. In particular, the FASB believes that more transparent, relevant information about changes in circumstances is provided to users of financial statements when changes in estimates of fulfilment cash flows are recognised immediately in profit or loss rather than offset by adjustments to the margin. Accordingly, the margin in the FASB's proposals (which incorporates implicitly in the margin established at contract inception both the contractual service margin and the risk adjustment) would not be adjusted to reflect changes in the estimates of the fulfilment cash flows.

BC30 In the responses to the IASB's 2010 Exposure Draft, many stated that the measurement of the insurance contract liability would not provide a faithful representation of the unearned profit that would be recognised over the remaining coverage period if the margin was not adjusted to reflect changes in estimates made after inception. Those with this view argued that it would be inconsistent to prohibit the recognition of gains at initial recognition, but then to require the subsequent recognition of gains on the basis of changes in estimates made immediately after initial recognition.

BC31 The IASB was persuaded by this view. As a result, this Exposure Draft proposes that differences between current and previous estimates of cash flows relating to future coverage or other future services would not be recognised in profit or loss immediately. Instead, they would be added to, or deducted from, the contractual service margin, and thereby recognised in profit or loss in future periods. The IASB's reasons are as follows:

(a) changes in estimates of cash flows relating to future coverage or other future services affect the future profitability of the contract. Thus, adjusting the contractual service margin to reflect these differences would provide a more faithful representation of the remaining unearned profit in the contract after inception.

(b) immediate recognition of adverse changes in estimates can make contracts that are profitable overall appear to be loss-making in some years. Conversely, it can also make contracts that become loss-making overall appear to be profitable in later years. Adjusting the contractual service margin to reflect changes in estimates of cash flows relating to future coverage and other future services would avoid these counter-intuitive effects.

(c) adjusting the contractual service margin to reflect changes in estimates relating to future coverage or other future services would increase consistency between measurement at inception and subsequent measurement.

(d) adjusting the contractual service margin for changes in estimates would make more transparent the effects of those changes in estimates because users of financial statements tend to place more weight on recurring changes in estimates than on one-time changes in estimates. Thus changes in estimates would be highlighted if they are recognised as part of the profit that the entity recognises in future periods, rather than all changes in estimates being recognised in the period in which they occur.

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:

(a) the contractual service margin would be increased as a result of favourable changes. There should not be a limit on the amount by which the contractual service margin could be increased. This is because favourable changes in estimates, whether lower than expected cash outflows or higher than expected cash inflows, increase the profit that the entity will recognise from the contract up to a maximum that is set by the amount of total expected cash inflows from the contract.

(b) the contractual service margin cannot be negative for insurance contracts that the entity issues. This means that once the contractual service margin has been exhausted, overall losses arising from the contract would be recognised immediately in profit or loss. This is because any excess of fulfilment cash flows over the contractual service margin would mean that the contract is expected to be onerous (ie loss-making), rather than profit-making, in the future. Such losses are recognised as an increase in the liability and corresponding expense in the period.

(c) only differences in estimates of cash flows relating to future coverage or other future services would result in an adjustment in the contractual service margin. Accordingly:

(i) the contractual service margin would not be adjusted for changes in estimates of incurred claims because these claims relate to past coverage. Such changes would be recognised immediately in profit or loss.

(ii) the contractual service margin would be adjusted for differences between expected and actual cash flows if those differences relate to future coverage; for example, if they relate to premiums received for future coverage. The entity would adjust the margin for both the change in premiums and any resulting changes in future cash outflows.

(iii) a delay or acceleration of repayments of investment components would adjust the contractual service margin only if future services are affected.

(iv) because changes attributable to gains or losses on underlying items do not relate to unearned profit from future services from the insurance contract, they would be recognised immediately in comprehensive income.

(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*[3], 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.

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[3] This Basis for Conclusions discusses the relationship between the proposals in this Exposure Draft and the 2011 Exposure Draft *Revenue from Contracts with Customers*. The IASB expects to finalise a Standard arising from that Exposure Draft during 2013. During redeliberations, the IASB has made significant changes to some of the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*. The IASB plans to consider the effect of those changes on the proposals in this Exposure Draft in due course.

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.

Complexity

BC35 As a result of the proposals to adjust the contractual service margin by changes in estimates relating to future coverage or other future services, there is an increase in complexity for both users and preparers of financial statements. For users of financial statements, complexity may rise from the need to understand how gains and losses arising from events of previous years affected current-year profit or loss. For preparers, complexity would arise from the need to identify separately the cash flows that would adjust the contractual service margin and those that would be recognised immediately in the statement of profit or loss and other comprehensive income. For both, a particular source of complexity arises from the distinction between changes in estimates relating to future coverage or other future services and experience adjustments relating to past coverage. That distinction may be subjective and vary according to when the entity makes the change in estimate. This is because a change in cash flows would be recognised as an adjustment to the contractual service margin if the entity changes its estimate of the cash flow before that cash flow occurred, but it would be recognised in profit or loss if the entity did not change its estimate and instead recognised an experience adjustment when the cash flow occurred.