IFRS™

STAFF PAPER

18-19 March 2014

REG IASB Meeting

Project	**Insurance contracts**		
Paper topic	How to unlock the contractual service margin—treatment of previously recognised losses		
CONTACT(S)	Joanna Yeoh	jyeoh@ifrs.org	+44 (0)20 7246 6481

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Objective

1. This paper discusses a follow-on issue that assumes that the IASB confirms the proposals in the IASB's 2013 Exposure Draft *Insurance Contracts* (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, as recommended in Agenda Paper 2A. Under the proposals in the ED:
   - (a) once the margin is exhausted, unfavourable changes between current and previous estimates of present value of those cash flows are recognised in profit or loss; and
   - (b) favourable changes between current and previous estimates of present value of those cash flows adjust the margin.

   These proposals are consistent with the rationale that unlocking would increase consistency between the determination of the margin on Day one and Day two. In addition, these proposals were largely supported by the feedback received.

2. This paper considers specifically the situation in which favourable changes in estimates occur after the margin is exhausted and unfavourable changes were previously recognised in profit or loss as losses. There are two alternatives for the treatment of those favourable changes:

(a) re-establish the margin immediately, as proposed in the ED (ie previously recognised losses would not be reversed profit or loss); or

(b) recognise favourable changes in profit or loss to the extent that they represent the reversal of losses previously recognised in profit or loss. If those favourable changes exceed previously recognised losses, re-establish the margin by the remainder of those changes.

3. This paper is structured as follows:

(a) the staff recommendation (paragraphs 4-5);

(b) the background on the proposals in the ED (paragraphs 6-7);

(c) a summary of feedback received on the proposals (paragraphs 8-14); and

(d) an analysis of the arguments for and against the two alternatives, including the rationale behind the staff recommendation (paragraphs 15-20).

Recommendations

4. The staff recommend that favourable changes in estimates that arise after losses were previously recognised in profit or loss should be recognised in profit or loss to the extent that they reverse those losses.

5. 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, or vice versa.

IASB ED

6. The ED proposed that adjustments to the contractual service margin should be recognised prospectively. After the adjustments are made, the outstanding margin is carried forward to be recognised in the future periods when the coverage or other services are provided. In other words, the effect of any adjustments would

be recognised in profit or loss over the coverage period that remains after the adjustments are made.

7. The IASB proposed that the margin should be adjusted prospectively because this would be significantly simpler to implement than adjusting the margin retrospectively. Adjusting the margin retrospectively would increase the consistency between how the contract is measured at inception and subsequently, and make the contract comparable to other contracts for which the same changes in estimates were determined at a different point of time. However, a retrospective adjustment would incur significant operational costs in tracking the development of the margin since inception. In addition, the benefits of carrying out a more precise adjustment in this instance are unlikely to outweigh the cost, because the measure of profitability represented by the margin is not the same as a 'true' measurement of the profit of the contract. This is because the margin is calibrated to the premium that was charged and not to the premium that the entity would charge at the reporting date, based on the estimates at the reporting date.

Summary of feedback received

8. Many respondents did not explicitly comment on the proposal to adjust the margin prospectively. The staff view this as an indication of support for the prospective approach to adjusting the margin, as proposed in the ED. Of those that did comment, most supported prospective adjustments.

9. However, many disagreed with specific application of the prospective approach as follows. Once the margin is exhausted, the margin would be adjusted with any future favourable changes and recognised over the remaining period over which coverage and other services are provided. This is illustrated using simplified assumptions in Example 1.

Example 1: Adjusting the margin prospectively after the margin is exhausted (ie not reversing previously recognised losses as proposed in the ED)

Assume for simplification that the time value of money and the risk adjustment are immaterial.

At inception, assume

Premiums paid	CU60[1]
Expected claims in Year 7	CU70
Losses	CU10

The journal entries are:

Dr Cash (premiums received)	CU60	
DR Losses	CU10	
CR Insurance liability		CU70

At the end of Year 2, the expectations of claims are revised from CU70 to CU55. Under the IASB ED proposals, the favourable adjustment of CU15 (CU70-CU55) is recognised as the margin.

	Before adjustment	Rebuild margin	After adjustment
Fulfilment cash flows	CU70	-CU15	CU55
Margin	CU0	+CU15	CU15
Total liability	CU70		CU70

The amount recognised in cumulative retained earnings for the contract remains as a loss of CU10. In future periods, the margin of CU15 is recognised in profit or loss.

When the contract is derecognised, cumulative equity is a gain of CU5 (CU15-CU10). This assumes no further adjustments to the margin.

10. Some acknowledge that determining the amount of losses that must be reversed would introduce complexity, because an entity would have to track the cumulative losses (negative margin) to determine the amount of the losses to be reversed if there are favourable changes in estimates. A few agreed with the IASB ED proposals and suggest that the complexity of tracking all unfavourable changes in

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

cash flows that had been previously recognised in profit or loss should not be imposed.

11. If losses were reversed, the complexity introduced is that the entity would need to track the margin when it is negative but not include it as part of the measurement of the liability on the balance sheet. This would mean that the negative margin for a portfolio of contracts is treated as if was positive as follows:

    (a) increased by further unfavourable changes recognised as losses;

    (b) decreased when there are favourable changes recognised as reversals in profit or loss;

    (c) decreased when contracts are derecognised so that the negative margin (ie accumulated losses) continues to represent the accumulated loss for the remaining portfolio of contracts; and

    (d) increased by the interest accreted to reflect the time value of money, which is consistent with the treatment of a positive margin and an onerous liability (Appendix A provides a simplified example of the relevant treatment of the reversal of onerous losses, which include any effects of the time value of money recognised on the onerous liability). This results in the amount of losses reversed is adjusted by the time value of money.

12. The staff think that there is no need to allocate a negative margin in the same way as a positive margin. This is because the negative margin represents losses that have already been recognised in profit or loss. In contrast, the positive margin has yet to be recognised in profit or loss. A positive margin is recognised in profit or loss using an allocation method that represents the profit that is earned as the transfer of services is provided. In addition, the staff believe that the objective of tracking a negative margin is so that previously recognised losses are reversed consistently with the treatment of an onerous liability in accordance with IAS 37. It would be consistent with the treatment of an onerous liability if the negative margin was not allocated.

13. Many, especially regulators, believe that reinstating losses through profit and loss before rebuilding the margin would provide a more faithful representation of the margin. Those that support this view believe that:

    (a) it would be more consistent with how the margin was determined at inception;

    (b) it would avoid distortion of the amount of retained earnings; and

    (c) it would avoid an entity reporting different amounts in Profit & Loss (P&L) depending on the frequency of reporting.

14. This approach is illustrated in Example 2. Furthermore, some preparers note that they already track information about losses recognised in P&L under their existing accounting practices and do not consider it burdensome. Accordingly, many constituents believe the additional complexity is justified.

Example 2: reversing previously recognised losses before rebuilding the margin

Assume the same facts on inception (ie a loss is recognised of CU10 and in Year 2 as set out in Example 1). For convenience, the facts for Year 2 are repeated. At the end of Year 2, the expectations of claims are revised from CU70 to CU55. The favourable adjustment of CU15 (CU70-CU55) is recognised by reversing previously accumulated losses of CU10 in profit or loss and the remainder as the margin.

	Before adjustment	Rebuild margin	After adjustment
Fulfilment cash flows	CU70	-CU15	CU55
Margin	CU0	+CU5	CU5
Liability	CU70		CU60

The amount recognised in cumulative retained earnings for the contract is now CU0 because the previous loss of CU10 is reversed. In future periods, the margin of CU5 is recognised in profit or loss.

When the contract is derecognised, cumulative equity is a gain of CU5 from the recognition of the margin. This assumes no further adjustments to the margin.

Analysis

15. This section discusses arguments for and against reversing previously recognised losses in profit or loss prior to rebuilding the margin.

*Arguments for **not** reversing previously recognised losses*

16. Arguments for **not** reversing previously recognised losses in profit or loss prior to rebuilding the margin (as proposed in the ED) are:

    (a) It is simpler not to reverse previously recognised losses. Reinstating previously recognised losses will require the entity to track those cumulative losses to determine the losses to be reversed when there are future favourable changes in estimates.

    (b) Reversing losses in profit or loss may make it more difficult for users to understand the amounts recognised in profit or loss in a reporting period. This is because users would need to know historical information about the losses to analyse the gains arising from the reversal of losses. They think it would be simpler to recognise only gains arising from the allocation of the margin, rather than also recognising gains representing the reversal of previously recognised losses.

Arguments for reversing previously recognised losses

17. The arguments for reinstating previously recognised losses in profit or loss prior to establishing the margin are:

    (a) Retained earnings more faithfully represent the cumulative losses or profit for the contract. If previously recognised losses are not reversed in profit or loss, a margin can be rebuilt for a contract that is considered loss-making overall. Some find this counterintuitive. For example, at inception a loss of CU10 is recognised. In Year 2, there is a favourable adjustment of CU4. If losses are not reversed through profit or loss, the margin is rebuilt by CU4 when overall the contract has cumulative losses of CU6 (CU10-CU4). The margin of CU4 suggests that the contract is profitable when it is still loss-making on a cumulative basis.

(b) It is consistent with similar requirements in IFRS. For example, reductions of previously recognised losses for onerous liabilities are recognised in profit or loss in accordance with the requirements for provisions and contingent liabilities (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). In addition, reversing previously recognised losses in profit or loss when there are favourable assumption changes is consistent with the requirements for onerous liabilities under the premium allocation approach.

(c) It increases the consistency of treatment between gains and losses. As a result, there would be increased consistency between entities that report quarterly and those who report annually of the amounts recognised in profit or loss and the margin. Some think that increasing the consistency of treatment between gains and losses would reduce an entity's ability to manipulate earnings. By not reinstating losses, entities could recognise future profits by using conservative assumptions when losses are recognised and subsequently reversing those conservative assumptions.

Conclusion

18. The staff recommends that entities should reverse previously recognised losses in profit or loss when there are favourable changes. Any favourable changes remaining after reversing previous losses should adjust the margin.

19. The staff agrees that reversing those losses will result in more representationally faithful cumulative retained earnings as discussed in paragraph 17(a). Furthermore, the staff think that reversing previously recognised losses in profit or loss will provide useful information to users, because it is consistent with the treatment of reversal of previously recognises losses on onerous contracts in other IFRS requirements and with the premium allocation approach as discussed in paragraph 17(b).

20. The staff think that the benefits of reversing previously recognised losses outweigh the additional complexity introduced by requiring the entity to track

cumulative losses. Feedback on the IASB proposals indicates that entities could do so relatively easily, because entities would need to track the margin when it is positive. Systems can then be configured to continue estimating the negative margin (ie the accumulated losses) as if it were positive. The only difference is that when the margin is negative, that margin is not part of the measurement of the liability on the balance sheet.

Question to the IASB

Question: reversing previously recognised losses
Does the IASB agree that favourable changes in estimates that arise after losses were previously recognised in profit or loss should be recognised in profit or loss to the extent that they reverse those losses? Any excess of favourable changes in estimates over losses previously recognised in profit or loss would rebuild the contractual service margin.

Appendix A: An example of the treatment of an onerous contract under IFRS

A1. The following is a simplified example to illustrate the treatment of an onerous contract liability under IFRS.

A2. At the start of Year 1, an onerous contract liability is recognised that the entity expects to settle in Year 7 by paying CU70. The present value of the expected settlement amount is CU50.

A3. The following are the journal entries for Year 1

1 January Year 1 – To recognise the onerous liability		
Dr Loss – onerous liability	CU50	
CR Provision for an onerous contract		CU50
31 December Year 1—To recognise the time value effects—unwind of the discount rate on the onerous contract liability		
Dr Interest Expense	CU2	
CR Provision for an onerous contract		CU2

A4. At the start of Year 2, a court ruling has determined that the entity is not obliged to settle the liability.

1 January Year 2—To derecognise the onerous contract liability	
Dr Provision for an onerous contract	CU52 (CU50+CU2)
CR Gain – reversal of previously recognised onerous liability	CU52

A5. When previously recognised losses on an onerous contract liability are reversed under IFRS, the amount reversed in profit or loss includes the losses previously recognised plus any time value effects recognised (eg interest expense).

A6. The paper proposes to reverse losses previously recognised in profit or loss when they are followed by favourable changes in estimates. To do this, entities would track losses previously recognised. Accreting interest on those tracked losses is consistent with the reversal of onerous liability in other IFRS as demonstrated above and with the measurement of the insurance contract liability, which recognises the effects of time value.