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STAFF PAPER

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REG IASB Meeting

Project	**Insurance contracts**
Paper topic	Cover note

CONTACT(S)	Andrea Pryde	apryde@ifrs.org	+44 (0)20 7246 6491
	Milena Lacheta	mlacheta@ifrs.org	+44 (0)20 7246 6494

Purpose of paper

1. This paper:
   - (a) Provides an overview of the papers for the April meeting, together with a summary of the staff recommendations (paragraphs 2-11)
   - (b) Provides a reminder of the background for the IASB's project on insurance contracts (paragraphs 12-17);
   - (c) Provides an overview of the accounting model proposed by the IASB's 2013 Exposure Draft *Insurance Contracts* ('the 2013 ED') (paragraphs 18-24); and
   - (d) Summarizes project progress and next steps (paragraphs 25-26);

Papers for this meeting

2. The agenda papers for this meeting consider contracts with participating features and four of the seven non-targeted issues that the IASB has agreed to consider.

Education session: Contracts with participating features

3. Agenda Paper 2A *Contracts with participating features: Background* provides background for Agenda Paper 2B *Possible adaptations for contracts with participating features* and the two papers should be read conjunctly.

4. Agenda Paper 2A describes the participating features that can be included in insurance contracts, the proposals in the 2013 Exposure Draft *Insurance Contracts* for contracts with participating features, and the response to the proposals in the comment letters. The paper includes two appendices. Appendix A describes some characteristics of contracts with participating features and Appendix B sets out the relevant references to the 2013 ED.

5. There are no staff recommendations in Agenda paper 2A.

6. Agenda Paper 2B *Possible adaptations for contracts with participating features* discusses whether adaptations for contracts with participating features are needed to the IASB's previous decisions for contracts with no participating features, and if so, what those adaptations are. The paper describes:

   (a) what the IASB's tentative decisions for contracts with no participating features are;

   (b) adaptations that the IASB could consider for contracts with participating features, including:

      (i) the adaptations the IASB proposed in the 2013 ED; and

      (ii) alternative adaptations proposed in the comment letters.

7. There are no staff recommendations in Agenda paper 2B.

Non-targeted issues – Recognising the contractual service margin in profit or loss

8. Agenda Paper 2C *Non-targeted issues – Recognising the contractual service margin in profit or loss* discusses whether to provide guidance on how to apply the principles on recognising the contractual service margin ('CSM') in profit or loss.

9. In Agenda Paper 2C the staff recommend that the IASB:

   (a) Confirms the principle that an entity should recognise the remaining CSM in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract; and

(b) Clarify that, for non-participating contracts, the service represented by the contractual service margin is insurance coverage which:

(i) is provided on the basis of the passage of time; and

(ii) reflects the expected number of contracts in force.

Non-targeted issues – fixed-fee service contracts, significant insurance risk, portfolio transfers and business combinations

10. Agenda Paper 2D *Non-targeted issues – fixed-fee service contracts, significant insurance risk, portfolio transfers and business combinations* discusses three of seven non-targeted issues that the IASB asked the staff to analyse further. The objective of Agenda Paper 2D is to provide further analysis of these issues and to recommend to the IASB how to address these issues.

11. In Agenda Paper 2D the staff recommend that the IASB:

(a) should permit, but not require, entities required, to apply the revenue recognition Standard to the fixed fee service contracts that meet the criteria stated in paragraph 7(e) of the 2013 ED

(b) clarify the guidance in paragraph B19 of the 2013 ED that significant insurance risk only occurs when there is a possibility that an issuer incurs a loss on a present value basis; and

(c) amend the requirements for the contracts acquired through a portfolio transfer or a business combination in paragraphs 43-45 of the 2013 ED, to clarify that such contracts should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or business combination.

Background for the IASB's project on insurance contracts

Objectives

12. At present, IFRS has no comprehensive standard that deals with the accounting for insurance contracts. IFRS 4, published in 2004, is an interim Standard that provides disclosures, but permits a wide range of practices and includes a 'temporary exemption', which explicitly states that an entity does not need to

ensure that its accounting policies are relevant to the economic decision-making needs of users of financial statements, or that those accounting policies are reliable. This means that:

(a) entities account for insurance contracts using different accounting models that evolved in each jurisdiction according to the products and regulations prevalent in that jurisdiction; and

(b) users of financial statements are not provided with all the information they need to understand the financial statements of entities that issue insurance contracts, or to make meaningful comparisons between entities.

13. The IASB's proposals are intended to improve financial reporting by providing more transparent, comparable information about:

(a) the effect of the insurance contracts an entity issues on the entity's financial performance;

(b) the way an entity makes profits or loss through underwriting risks and investing premiums from customers; and

(c) the nature and extent of risks that an entity is exposed to as a result of issuing insurance contracts.

Building on previous consultation

14. The 2013 ED builds on the proposals previously set out in:

(a) the Discussion Paper *Preliminary Views on Insurance Contracts*, published in May 2007, which explained the IASB's initial views on insurance contracts; and

(b) the Exposure Draft *Insurance Contracts* (the '2010 ED'), published in July 2010, which developed those initial views into a draft Standard.

15. The feedback received on the IASB's earlier documents confirmed that there was widespread acceptance of the proposed approach to measure insurance contracts using a current, market-consistent approach (see paragraphs 17-23). That feedback indicated that many agree that such an approach would provide financial

information that is relevant to users of the financial statements of entities that issue insurance contracts, and would faithfully represent the financial position and performance of such entities. As a result of this previous work, the IASB was satisfied that its measurement model for insurance contracts is appropriate and would result in improvements to financial reporting.

16. However, in response to issues identified in the comment letters, the IASB made some significant changes to the proposals in the 2010 ED. The IASB believes that those changes would increase the faithfulness of representation of insurance contracts in financial statements, and lead to entities providing more relevant and timely information about insurance contracts compared to the proposals in the 2010 ED. However, these proposals would be more complex to apply than the proposals in the 2010 ED. Accordingly, while the 2013 ED contained a complete draft of the proposed Standard on insurance contracts so that interested parties could consider the proposals in context, the IASB sought input only on the following five proposals:

    (a) That an entity should recognise any change in estimates relating to future service in the period in which the service is provided (ie to ‘unlock’ the contractual service margin); and

    (b) That there should be a measurement and presentation exception to reflect situations in which there can be no economic mismatches between the insurance contract and assets backing that contract.

    (c) That an entity should present insurance contracts revenue that is consistent with the principles for the revenue that is required by other IFRSs for other contracts with customers. Accordingly, an entity would depict the transfer of promised services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services, measured as a reduction in the entity’s performance obligations;

    (d) That an entity should present interest expense from insurance contracts in a way that enables an amortised cost-based expense to be presented in profit or loss and current-value-based measurement to be presented in the balance sheet.

(e) That the transition approach should be amended to improve comparability for contracts originated before and after application of the proposals. The proposed transition approach specified some simplifications that maximise the use of objective data.

17. The IASB also sought input on whether the costs of implementing the proposed Standard would be justified by the benefits of the information provided overall. However, in publishing the 2013 ED, the IASB stated its intent that it would not revisit issues that it has previously rejected or reconsider consequences it has previously considered.

The accounting model proposed by the IASB

18. The 2013 ED proposes that an entity should measure insurance contracts using a current value approach that incorporates all of the available information in a way that is consistent with observable market information. As a result, the IASB has tentatively decided that the measurement of an insurance contract should incorporate a current, unbiased estimate of the cash flows expected to fulfill the liability, reflect the time value of money, risk and uncertainty and be calibrated at inception to the premium (except when onerous).

19. In addition, the 2013 ED proposed a presentation approach that would reflect (a) underwriting experience, the change in uncertainty and the profit from services in the period and, (b) through the interest and discount rate changes, both a current and a cost-based view of the cost of financing the insurance contract.

20. The IASB believes that the use of a current value measurement model for the insurance contracts liability is desirable for three important reasons:

(a) It provides transparent reporting of changes in the insurance contract liability, including changes in the economic value of options and guarantees embedded in insurance contracts.

(b) It provides complete information about changes in estimates.

(c) It means that the assets and liabilities of an entity can be measured on a consistent basis[1], thus reducing accounting mismatch in comprehensive income and equity.

21. However, in a current measurement model, reported volatility can arise if there are economic or accounting mismatches. In other words, volatility arises:

(a) if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. When such **economic mismatches** occur, market fluctuations give rise to real economic effects. When combined with a current measurement of the assets, a current measurement of the liability portrays those effects. This may result in reported volatility which the IASB believes faithfully represents the underlying economics.

(b) if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because they are measured on different bases. The IASB seeks to eliminate such **accounting mismatches.**

22. The extent of reported volatility arising from a current value approach was a critical issue in the feedback to the 2010 ED. The proposals in the 2013 ED would reduce the extent of reported volatility as follows:

(a) The IASB confirmed that both a top-down and a bottom-up approach can achieve the objective of the discount rate and that the entity can decide which approach is best in its circumstances. The top-down approach significantly reduces accounting mismatch arising from the effect of credit spread changes by reflecting the effect of credit spread changes in both the asset and liability measurement.

(b) The IASB decided to adjust (ie ‘unlock’) the contractual service margin for differences between current and previous estimates of cash flows relating to future coverage or other future services. This means that the

[1] Ie assuming that assets are measured at fair value

effect of changes in estimates of cash flows would be reported over the remaining coverage period, rather in the period of change.

(c) The IASB decided to present the changes in the insurance contract liability arising from changes in the discount rate in OCI, rather than in profit or loss.

(d) The IASB decided that, for contracts which create a contractual link between the underlying items and the insurance contract liabilities, the measurement and presentation of the liabilities should mirror the measurement and presentation of the assets. Consequently, volatility arising from accounting mismatch is reduced for such contracts.

23. Nonetheless, volatility from both accounting and economic mismatches remains an important issue in the feedback on the 2013 ED, particularly for participating contracts.

24. As a consequence of these decisions, there is additional complexity in understanding how changes in estimates are treated under the model. The following table summarises the treatment of changes in estimates.

Type of change in estimate	Where recognised
Change in present value of cash flows relating to future service	Adjust contractual service margin, and recognised in profit or loss when future service provided
Change in present value of cash flows relating to past and current periods' service (ie experience adjustments)	In profit or loss in the period of change (underwriting result)
Change in present value of cash flows unrelated to service (for example, some deposits)	In profit or loss in the period of change (net interest and investment)
Unwinding of discount based on discount rate at inception	In profit or loss in period of unwind (net interest and investment)

Effect of changes in discount rates on the measurement of liability	In other comprehensive income in the period of change
Changes in the risk adjustment (relating to current, past and future service)	In profit or loss in the period of change

Project progress and next steps

25. At this meeting the IASB will have addressed three of the five topics targeted in its 2013 ED as they apply to non-participating contracts and four of the same non-targeted issues that the IASB agreed to consider. The IASB will have also begun deliberations of contracts with participating features. In future meetings the staff plans to address the issues relating to:

    (a) contracts with participating features

    (b) follow-up issues relating to OCI and unlocking;

    (c) unit of account;

    (d) long duration discount rates;

    (e) asymmetrical treatment of reinsurance contracts; and

    (f) transition in the context of a near final model.

26. The IASB expects that redeliberations of its proposals for the accounting for insurance contracts will be completed in 2014, with the publication of a final Standard following in 2015.

Appendix A: Summary of changes from the 2013 ED

The following table presents a summary of changes from the 2013 ED.

Proposal in the 2013 ED	Confirmed principle	Revision of the 2013 ED proposal
Changes in discount rate presented in OCI	✓	Accounting policy choice at portfolio level for the effect of changes in discount rate to be presented in P&L or OCI Disclosures that would disaggregate the change in interest expense into its component parts and that would allow their comparison
Unlocking the CSM	✓	Changes in estimates of risk adjustment relating to future service also recognised in period when service is provided Reversal of previously recognised losses before margin is rebuilt
Insurance contracts revenue	✓	Prohibit presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue
Mirroring approach	TBD	TBD
Transition	TBD	TBD

Appendix B: Tentative decisions to date

The following table presents a summary of tentative decisions made in the redeliberations phase in 2014:

Tentative decisions	Follow up
1. Unlocking the contractual service margin	
(a) Differences between the current and previous estimates of the present value of cash flows and the risk adjustment 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. (b) Differences between the current and previous estimates of the present value of cash flows and the risk adjustment that do not relate to future coverage and other future services should be recognised immediately in profit or loss. (c) 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 losses that related to coverage and other services in the future.	• Interaction between unlocking contractual service margin and use of OCI • Application to contracts with participating features
2. Recognising the effects of changes in the discount rate in other comprehensive income	
(a) An entity should choose to present the effect of changes in discount rates in profit or loss, or in other comprehensive income as its accounting policy and should apply that accounting policy to all contracts within a portfolio (b) If the entity chooses to present the effect of changes in discount rates in other comprehensive income, the entity should: (i) Recognise in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised; and	• Whether there should be guidance that entities should apply the same accounting policy to groups of similar portfolios and the interaction with the definition of a portfolio • More guidance on when an entity can change its accounting policy choice based on the requirements for

(ii) Recognise in other comprehensive income, the differences between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract was initially recognised. (iii) Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum to: 1. interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in profit or loss for the period; and 2. the movement in other comprehensive income for the period. (c) An entity should disaggregate total interest expense included in total comprehensive income to: (i) the amount of interest accretion determined using current discount rates (ii) the effect on the measurement of the insurance contract of changes in discount rates in the period; and (iii) the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the contractual service margin when measured at current rates.	changing accounting policy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. • Interaction between unlocking the contractual service margin and use of OCI • Application to contracts with participating features
3. Presenting insurance contracts revenue and expense in the statement of comprehensive income	
a) An entity should present insurance contract revenue and expense in the statement of comprehensive income, as proposed in paragraphs 56–59 and B88–B91 of the 2013 ED; and	• Application to contracts with participating features

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b) An entity should disclose the following:
(i) a reconciliation that separately reconciles the opening and closing balances of the components of the insurance contract asset or liability (paragraph 76 of the 2013 ED);
(ii) a reconciliation from the premiums received in the period to the insurance contract revenue in the period (paragraph 79 of the 2013 ED);
(iii) the inputs used when determining the insurance contract revenue that is recognised in the period (paragraph 81(a) of the 2013 ED); and
(iv) the effect of the insurance contracts that are initially recognised in the period on the amounts that are recognised in the statement of financial position (paragraph 81(b) of the 2013 ED).
c) An entity should be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue.
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<tr><td colspan="2">4. Project plan for the non-targeted issues</td></tr>
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The IASB tentatively decided:
a) to consider in future meetings the following non-targeted issues:
(i) references to ‘unit of account’ and ‘portfolio’ in the 2013 ED and whether it will be possible to clarify the IASB’s intentions and provide more consistency;
(ii) whether to provide further guidance regarding discount rate for long-term contracts when there is little or no observable market data;
(iii) whether in some circumstances there is an accounting, rather than an economic mismatch between insurance contracts and reinsurance contracts because of the asymmetrical treatment of their contractual service margins, and if so, whether such a mismatch could be mitigated;
(iv) whether to provide more guidance on an
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appropriate allocation pattern for the contractual service margin; (v) whether to provide guidance for the significant insurance risk definition for a specific contract; (vi) whether the requirements for portfolio transfers and business combinations could be simplified and clarified; and (vii) whether to provide an option for fixed-fee service contracts. b) not to consider in future meetings other non-targeted issues, including those relating to: (i) disclosures; (ii) premium allocation approach; (iii) combination of insurance contracts; (iv) contract boundary for specific contracts; (v) unbundling—lapse together criteria; (vi) treatment of ceding commissions; (vii) discount rate—top-down and bottom-up approaches; (viii) tax included in the measurement; and (ix) combining the contractual service margin with other comprehensive income.	