STAFF PAPER

May 2014

IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Non-targeted issues - Recognising the contractual service margin in profit or loss		
CONTACT(S)	Conor Geraghty	cgeraghty@ifrs.org	+44(0)20 7246 0553
	Izabela Ruta	iruta@ifrs.org	+44 (0)20 7246 6957

Purpose of this paper

1. During its meeting in April 2014, the IASB discussed the project plan for issues raised in the comment letters that were outside the five areas that were targeted for input in the IASB's 2013 Exposure Draft *Insurance Contracts* ('the 2013 ED')[1]. At that meeting, the IASB agreed to discuss seven issues as part of the insurance contracts project plan, because in the IASB's opinion these issues might need addressing further. This paper discusses one of those issues, namely whether to provide guidance on how to apply the principles on recognising the contractual service margin ('CSM') in profit or loss.

2. This paper does not consider the following:

   (a) the recognition in profit or loss of the CSM for contracts with participating features;

   (b) the accretion of interest on the carrying amount of the CSM; and

   (c) the recognition in profit or loss of the liability for remaining coverage for insurance contracts subject to the premium allocation approach.

[1] See Agenda Paper 2C *Project plan for the non-targeted issues* that is available on http://www.ifrs.org/Meetings/Pages/IASB-Apr-14.aspx

Those topics would be discussed at a future meeting.

Why does the IASB need to address this issue?

3. The 2013 ED proposed 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 services that are provided under the contract.

4. Many respondents observe that the allocation pattern for the CSM will have a material impact on the profit reported by entities. In the light of this observation, some respondents were concerned that, without further guidance, the subjectivity in determining the pattern of underlying services will create significant diversity in the pattern of recognition of the CSM in profit or loss.

5. Accordingly, at its April 2014 meeting, the IASB agreed to consider whether to provide more guidance on appropriate allocation patterns for the CSM.

Staff recommendation

6. The staff recommend that the Board:
    - (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.

Structure of paper

7. This paper is structured as follows:

(a) Paragraphs 8 to 17 describe the background to the proposals in the 2010 and 2013 EDs and the feedback that the IASB received.

(b) Paragraphs 18 to 47 provide the staff analysis.

(c) In paragraph 48 the staff provide recommendations and ask questions to the Board.

(d) Appendix A contains examples of CSM recognition on a time basis – with and without reference to expected contract terminations.

(e) Appendix B contains relevant extracts from the 2013 ED and the Basis for Conclusions.

Background

2010 ED proposal and feedback received

Basis for recognition of the contractual service margin in profit or loss

8. The 2010 Exposure Draft *Insurance Contracts* ('the 2010 ED') proposed that an insurer should recognise the contractual service margin[2] for insurance contracts as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

   (a) on the basis of the passage of time, but

   (b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

9. The 2010 ED did not consider asset management services provided in participating insurance contracts specifically, other than for financial instruments that contain discretionary participating features ('DPF'). The 2010 ED proposed that the CSM for financial instruments with DPF be recognised in profit or loss in a systematic way that best reflects the asset management services, as follows:

   (a) On the basis of the passage of time, but

[2] The 2010 ED named the contractual service margin – a residual margin.

(b) On the basis of the fair value of assets under management, if that pattern differs significantly from the passage of time.

10. The feedback received from comment letters and outreach activities for these proposals in the 2010 ED was mixed. Many constituents believed that neither the passage of time nor the expected pattern of incurred claims and benefits would reflect the exposure from insurance coverage for all insurance contracts. In particular, constituents noted that if the expected timing of incurred claims and benefits was applied to long duration life insurance contracts, the CSM would be recognised primarily towards the end of the coverage period. They noted that this effect was magnified by the accretion of interest on the remaining CSM.

Level of aggregation

11. The Basis for Conclusions on the 2010 ED noted that in order to recognise the CSM in profit or loss over the coverage period, it was necessary to group together contracts within the portfolio that have similar dates of inception and similar coverage periods (sometimes referred to as cohorts). In addition, the 2010 ED proposed that if fewer contracts are in force at the end of a period than was expected at the beginning of the period, the amount of the CSM recognised in profit or loss during the period should include an adjustment to eliminate from the CSM at the end of the reporting period the portion relating to contracts that are no longer in force.

12. Several respondents disagreed with the IASB's proposed requirement to aggregate contracts into cohorts for the purposes of releasing the CSM to profit or loss. Some believed that it would be very complex to track the CSM at a cohort level. Others believed that the objective to fully recognise the CSM by the end of the coverage period can be achieved by other means than an aggregation on a cohort level.

2013 ED proposal and feedback received

13. After considering the feedback received on the 2010 ED, the IASB deleted the proposed guidance, and instead included more principle-based proposals related to the allocation of the CSM, as follows:

(a) 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 services that are provided under the contract.

(b) An entity should measure the amount of CSM recognised in profit or loss at a level of aggregation[3] such that once the coverage period of the insurance contract has ended, the related CSM has been fully recognised in profit or loss.

14. In addition, the IASB proposed that the CSM should be adjusted by changes in estimates of cash flows relating to future service. That decision places more importance on the allocation of the CSM in order to ensure that entities do not inappropriately delay profit recognition to have enough remaining CSM to offset future negative changes in expected cash flows or risk adjustment.[4]

15. Constituents supported the principle that the CSM be recognised in profit or loss in a systematic way to reflect the transfer of services provided under an insurance contract. However there were differing views on the amount of guidance that should be provided:

(a) A few preparers and industry groups welcomed the principles-based approach of the 2013 ED, noting that prescription of methods would be arbitrary and may not faithfully represent the provision of service under the wide range of insurance contracts that exist.

(b) In contrast, many constituents, including standard setters, auditors and professional bodies, asked for more guidance on the application of the principle. Specific topics for which guidance was sought included:

(i) What is the service under an insurance contract; and

[3] The level of aggregation at which the CSM measured is not considered further in this paper, but will form part of a wider discussion on the unit of account and the definition of a portfolio at a future meeting of the Board.

[4] The importance of the allocation of the CSM has been increased further by the tentative decision taken by the Board at its March 2014 meeting to adjust the CSM after inception to reflect differences between the current and previous estimates of the risk adjustment related to future coverage.

(ii) What is the pattern of services provided and, therefore, what is the pattern of recognition of the CSM in profit or loss.

16. Several respondents were concerned about the potential range of interpretations of the principles in the 2013 ED on the recognition of the CSM in profit or loss. In the staff's view the lack of a consistent basis for profit recognition may lead to:

(a) Diversity of practice, and consequently different levels of profit reported in a period by entities in respect of similar products in similar circumstances;

(b) Inability for users to understand or predict profits; and

(c) Increased risk of profit manipulation.

17. Several respondents did not agree that the CSM should be recognised over the coverage period and said that the CSM should be recognised over the coverage and settlement periods as they believe that claims handling is a significant service in some insurance contracts.

Staff analysis

18. The staff analysis is structured as follows:

(a) In paragraphs 19 to 25 the staff consider what services are provided in insurance contracts. This is because the CSM represents the performance obligation to provide service, measured at inception at the amount of profit that the entity expects to earn over the coverage period. Therefore we need to understand the pattern of services provided under an insurance contract to determine the pattern for recognising the CSM.

(b) In paragraphs 26 to 43 the staff consider how the pattern of transfer of insurance coverage could be measured over the coverage period.

(c) In paragraphs 44 to 47 the staff consider whether guidance on the recognition of the CSM in profit or loss to reflect the transfer of the service of insurance coverage is necessary.

What is not a service provided by an insurance contract

19. Consistent with the proposals in Exposure Draft *Revenue from Contracts with Customers* that was published by the IASB in November 2011 ('the Revenue Recognition ED')[5] the proposals in the 2013 ED distinguish the provision of service from other activities that the entity must undertake to fulfil a contract. Paragraph 25 of the Revenue Recognition ED states that the performance of such tasks does not transfer a service to the customer as the tasks are performed. Accordingly:

    (a) asset management activities that are undertaken in relation to non-participating contracts do not transfer a service to policyholders; and

    (b) claims handling does not transfer a service to the policyholder.

    These activities are discussed below.

Is asset management a service in an insurance contract?

20. Asset management activities do not necessarily transfer a service to the policyholder. Some non-participating contracts, for example, endowment products, provide a fixed return on maturity. The entity must undertake asset management activities to ensure it is able to provide that fixed return on maturity. However, that asset management activity has no effect on the benefit to the policyholder, and therefore there is no asset management service provided to the policyholder. In contrast, asset management activity affects the returns to the policyholders in a contract with a participating feature, and hence can be considered to provide a service to the policyholders.

Is claims handling a service in an insurance contract?

21. Several respondents have stated that claims handling is a significant service of insurance contracts and consequently the CSM should be recognised in profit or loss over a period that extends beyond the coverage period to the time when claims are settled.

[5] The final standard *Revenue from Contract with Customers* is due to be published shortly after this paper is finalised. The proposals in the Revenue Recognition ED referred to in this paper have not changed significantly since the Revenue Recognition ED

22. The 2010 and 2013 EDs both treated claims handling as an operating activity of an insurer that is necessary to fulfil obligations arising from the provision of insurance coverage rather than as an additional service to policyholders. There are several reasons for this treatment:

    (a) The form in which an insurer fulfils obligations arising from the provision of insurance coverage should not affect the profit recognition. For example, a health insurer could arrange for physiotherapy for an injured policyholder or it could reimburse policyholders who obtain their own physiotherapy services.

    (b) Claims handling activities are to a large extent, and sometimes exclusively, performed for the benefit of the insurer, with the focus on the following:

        (i) ensuring that claims are valid in accordance with the terms and conditions of the contract; and

        (ii) using the insurer's expertise to process claims efficiently and minimise its costs, for example, by the use of approved suppliers of goods and services with whom competitive prices have been agreed and negotiations with third parties to settle claims against the insured

23. The staff conclude that claims handling is not a service in an insurance contract.

What services are provided under an insurance contract?

24. The defining feature of an insurance contract is that an entity provides insurance coverage to a policyholder. In other words, the entity provides the service of standing ready to compensate a policyholder if an insured event takes place during the coverage period.

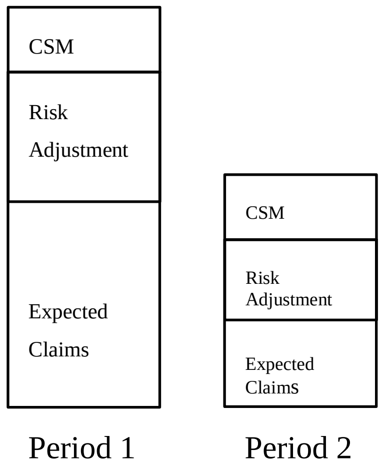
25. Insurance contracts may provide additional services, for example, asset management services. Because such services are provided only when returns to policyholders vary with the returns on underlying items, they are a feature of contracts with participating features. Contracts with participating features are discussed in agenda papers 2A and 2B for this meeting. We will consider the

appropriate recognition pattern for the CSM in contracts with participating features at a future meeting.

How should transfer of insurance coverage be measured?

CSMs in a series of forward starting insurance contracts

26. In concept, the service of insurance coverage provided at different times in a coverage period could be estimated by considering what the CSMs would be in a series of forward starting insurance contracts that span the coverage period. For example, suppose the coverage period of an insurance contract is divided into two shorter periods of equal length, of which one has risk adjusted expected claims that are ten times greater than the other period. The question we are trying to answer is: what would be the CSM for each period?



27. The staff thinks that, without observable market prices for each component, estimating the CSM for each period objectively would not be feasible and the staff doubts whether such observable data would exist in many circumstances. Entities would need to estimate the premiums and the fulfilment cash flows for these theoretical contracts in order to determine the CSM for each. In practice, the CSM in the two periods would be a product of factors that are internal to the entity, for example, the need to recover overheads and generate a return on shareholder

investment[6], and external factors such as propensity for policyholders to purchase insurance and market competition in each period.

28. The staff concluded that providing guidance that the CSM should be consistent with the pattern of CSMs in a series of forward starting insurance contracts would not be practical, and it would not address concerns about a lack of comparability and understandability of profits and the risk of results management.

29. Having rejected this 'direct measurement' of CSMs over the coverage period, the staff sought guidance on the provision of service, and hence recognition of the CSM, from the Revenue Recognition ED.

Considering the guidance in the Revenue Recognition ED

30. The Revenue Recognition ED provides guidance on how to measure progress towards satisfying a performance obligation to transfer goods or services, including:

    (a) The objective when measuring progress towards complete satisfaction of a performance obligation is to depict the transfer of control of goods or services; and

    (b) the appropriate methods of measuring progress include output methods and input methods.

31. Output methods measure progress to complete satisfaction of a performance obligation, on the basis of direct measurements of the value to the customer of the goods or services transferred to date, relative to the remaining goods or services promised under the contract. Output methods for measuring progress include milestones reached, time elapsed, appraisals of results achieved, etc.

32. The Revenue Recognition ED notes that a disadvantage of output methods is that they are often not directly observable and the information required to apply them may not be available to the entity without undue cost. Consequently, it proposes that entities should use input methods as an alternative measure of transfer of

[6] Note that the risk adjustment is set at a level at which the entity is indifferent about the potential variability of expected cash flows, consequently the target return that forms an input to the CSM is after risk is taken into consideration.

performance obligation. Input methods use the entity's efforts or inputs to measure the satisfaction of a performance obligation (for example, resources consumed, costs incurred or time lapsed) relative to the total expected inputs to the satisfaction of that performance obligation. The Revenue Recognition ED notes that a shortcoming of input methods is that there may not be a direct relationship between the entity's inputs and the transfer of control of goods or services to a customer.

33. Applying that guidance to insurance contracts, the staff observe that the value of insurance coverage to a policyholder will depend to some extent on their personal circumstances (age, financial needs, e.g., dependants) and aversion to risk. Consequently, in practice it may not be feasible to measure this 'value' to policyholders objectively in order to apply an output method to measure progress to satisfying an obligation to transfer the service of insurance coverage.

34. Accordingly, an entity would apply an input method to measure such progress. For insurance contracts, the inputs include the expected claims and benefits, the risk borne and the passage of time.

What is the pattern of transfer of insurance coverage?

35. The staff have considered whether the transfer of insurance coverage is uniform over time or whether the pattern of transfer should also reflect factors such as variations in the amount of expected claims or the amount of risk relating to each period. Both the amount of expected claims and the amount of risk relating to each period represent a cost to the insurer of accepting insurance risk and providing coverage.

36. However, these costs have already been taken into account in arriving at the carrying amount of the CSM. Expected claims are reflected in the cash flows that form part of insurance contract liabilities. Variances between actual and expected cash flows are recognised in profit or loss as experience adjustments. The amount of risk related to each period is reflected in the risk adjustment and is recognised in profit or loss as the entity is released from risk. Insurance coverage is standing ready; it is not settling the liabilities that arise from standing ready. Hence, the

only input that has not been considered in determining the CSM is the passage of time.

37. Insurance coverage is transferred to policyholders on a continuous basis throughout the coverage period as the entity stands ready to compensate policyholders if insured events occur. Therefore time is one of the key input methods for measuring progress in providing insurance coverage.

38. A time-based approach to recognising the CSM in profit or loss in respect of the service of insurance coverage has a number of benefits:

    (a) It is consistent with the principle of standing ready to provide insurance coverage over time;

    (b) it is relatively easy for preparers to apply;

    (c) it is relatively easy for users to understand and predict the resulting profit;

    (d) the staff believe that it would be relatively easy to audit;

    (e) it would help to increase consistency in profit reporting between entities; and

    (f) it would make profit management more difficult than a more complex or subjective approach.

39. Other patterns of recognition of the CSM, for example, the pattern of expected claims, or the sum of expected claims and release of the risk adjustment over the coverage period, are no less arbitrary than a time-basis, and may not address concerns about comparability and understandability of profit and the risk of result management

The pattern of service needs to reflect the expected number of contracts in force

40. If an entity were to recognise the CSM on the basis of the passage of time, the staff notes that the total amount of insurance coverage transferred in respect of a portfolio of contracts in a reporting period depends on the number of contracts that are in force during the period. An entity would expect to transfer more

insurance coverage service, and hence to recognise a greater proportion of the CSM to profit or loss, in the early years of the coverage period for a group of contracts if it expects a significant proportion of insurance contracts to terminate before the end of their term, whether due to death claims or lapses, etc

41. If more contracts terminate in a period than was expected at the beginning of the period, it may be necessary to derecognise the element of the CSM that relates to them. If fewer contracts terminate in a period than expected it may be necessary to re-estimate fulfilment cash flows, and adjust the CSM accordingly, and use the revised expectation of future service to determine the pattern of future CSM recognition.

42. Allowing for expected contract terminations enables a more accurate calculation of the proportion of total service that is provided in the current period, and hence the proportion of CSM to be recognised in profit or loss. In Appendix A, the staff provide an example that compares CSM recognition on a time basis with and without allowing for expected contract terminations. The purpose of the example is to demonstrate the necessity of using expected contract terminations to:

    (a) calculate the number of expected insurance coverage hours to be provided, and hence the proportion of total service provided in a period, and

    (b) minimise catch up adjustments to derecognise the CSM for contracts no longer in force.

43. The fulfilment cash flows and the carrying amount of the CSM for a portfolio of life insurance contracts reflect the expected level and timing of contract terminations at each period end. This is the best information available to estimate the contract coverage hours in a current reporting period as a proportion of total remaining coverage hours for all contracts and hence the basis for releasing the CSM to profit or loss.

Is guidance on how to recognise the CSM in profit or loss for insurance coverage required?

44. The staff agree with constituents who believe that there is a need for guidance on how to apply the 2013 ED principle of recognising CSM in profit or loss. One of the concerns of constituents was a lack of comparability between the profit recognition profile for similar products of different entities. For example, without additional guidance, an insurer could choose opposite patterns to recognise the CSM in profit or loss for an endowment contract:

    (a) An entity could reasonably assume that service is provided according to the expected pattern of payments to policyholders over the coverage period (including deposit components), which would 'back-end' recognition of profit; or alternatively

    (b) An entity could assume that the service is accepting exposure to loss, and consequently use the pattern of the net amount at risk (face value of potential claims minus cash surrender value) over the coverage period as the basis for profit recognition, which would 'front-end' the recognition of profit.

45. Similarly, straight line recognition (passage of time) and the pattern of release from risk over the coverage period could also lead to significantly different profit recognition profiles for similar insurance products.

46. The staff believe that the potential range of approaches to recognising the CSM in profit or loss would be confusing to users of financial statements, and that guidance is required to help preparers and users to understand what profit from providing the service of insurance coverage represents and to limit the choices available.

47. Furthermore, the staff note that the Board's tentative decisions to adjust the CSM for changes in estimates of cash flows and risk adjustment relating to future service places more importance on the need to ensure a consistent recognition approach for the CSM. This is because there may be an incentive for entities to delay profit recognition to make sure that there is enough remaining CSM to

offset future negative changes in expected cash flows or risk adjustment (unlocking).

Staff Recommendations:

48. The staff recommend that the Board:

    (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.

Questions for board members
1) Does the Board agree that it should confirm the proposals in the 2013 ED that the remaining contractual service margin should be recognised in profit or loss in a systematic way that reflects the provision of the service of insurance? 2) Does the Board agree to add guidance that that, for non-participating insurance contracts, the service represented by the contractual service margin is insurance coverage which: a) is provided on the basis of the passage of time; and b) reflects the expected number of contracts in force.

Appendix A: Comparison of CSM recognition pattern on a passage of time basis with and without reference to expected contract terminations

A1. In the example below, the staff compare two methods of including contract terminations in the recognition pattern of the CSM on a time basis. In this example contract terminations are due to lapses.

a. Method A assumes that expected contract lapses are taken into account when estimating the release pattern of the CSM; and

b. Method B assumes that the CSM is released without reference to expected future lapses but derecognising the element of CSM relating to lapses as they happen.

A2. The purpose of the example is to demonstrate the benefits of using Method A based on expected contract lapses which would avoid catch up adjustments to derecognise the CSM for contracts no longer in force.

Method A

A3. This example assumes that:

a. Portfolio coverage period equals 10 years;

b. The CSM at inception equals CU10,000; and

c. 50% of the contracts are expected to lapse at the end of Year 3. This example is extreme to highlight the effects of using both methods

A4. Method A includes expected contract lapses to calculate the number of expected insurance coverage hours to be provided. The results may be summarised as follows:

	Yr 1	Yr 2	Yr 3	Yr 4	….	Yr 10
A) Expected/Actual policy count at end of year	100	100	50	50		50
B) Number of 'coverage years' provided (assuming lapses occur immediately prior to the end of Year 3)	100	100	100	50		50
C) Cumulative number of expected coverage years (Σ current & future for row B)	650	550	450	350		50
D) Proportion of remaining coverage years provided in current reporting period (B/C)	15.4%	18.2%	22.2%	14.3%		100%

Reconciliation of the CSM

E) CSM at the opening balance (CU)	10,000	8,462	6,924	5,386		769
F) True up expected to actual lapses*	-	-	-	-		-
G) Recognition of CSM in P&L on expected basis (E x D)	(1,538)	(1,538)	(1,538)	(769)		(769)
H) CSM at the closing balance	8,462	6,924	5,386	4,617		-

* Additional adjustment might be needed if the actual lapses are different comparing to expected lapses for the period

Method B

A5. The example assumptions are the same as for the Method A.

A6. This Method releases the CSM based on the assumption that all contracts are in force and that lapses adjust the profit recognised for the period as they happen. The outcome of this Method is illustrated in the table below:

	Yr 1	Yr 2	Yr 3	Yr 4	….	Yr 10
J) Actual policy count at end of year	100	100	50	50		50
K) Proportion of policies at start of period that lapse in the period	0%	0%	50%	0%		0%

Reconciliation of the CSM

	Yr 1	Yr 2	Yr 3	Yr 4	….	Yr 10
L) CSM at the opening balance (CU)	10,000	9,000	8,000	3,500		500
M) Release of CSM to P&L on time basis (opening balance / number of remaining reporting periods)	(1,000)	(1,000)	(1,000)	(500)		(500)
N) Sub total	9,000	8,000	7,000	3,000		-
P) Catch up adjustment for actual lapses (K x N)	-	-	(3,500)	-		-
Q) CSM at closing balance	9,000	8,000	3,500	3,000		-

A7. The table below includes a comparison of the CSM recognition in profit or loss according to methods A and B.

	Yr 1	Yr 2	Yr 3	Yr 4	….	Yr 10
R) CSM release according to Method A – use expected claims (G)	(1,538)	(1,538)	(1,538)	(769)		(769)
S) CSM release according to Method B – does not use expected claims (M + P)	(1,000)	(1,000)	(4,500)	(500)		(500)
Difference (R – S)	(538)	(538)	2,962	(269)		(269)

A8. The staff believe that Method A provides a better representation of the services provided each period. Method B recognises CSM in the profit or loss assuming that all contracts are in force over the coverage period. Consequently, a catch up adjustment is necessary at the end of Year 3 to recognise profit relating to contracts that are no longer in force. The staff believe that such catch up adjustments do not represent service provided in a period.

Appendix B: Relevant paragraphs from 2013 ED and BC.

Contractual service margin (paragraphs 28 to 32)

Contractual service margin

28 **Unless the portfolio of insurance contracts that includes the contract is onerous at initial recognition, an entity shall measure the contractual service margin recognised at initial recognition in accordance with paragraph 18(b) at an amount that is equal and opposite to the sum of:**

(a) **the amount of the fulfilment cash flows for the insurance contract at initial recognition; and**

(b) **any pre-coverage cash flows.**

Subsequent measurement

29 **Unless paragraphs 35–40 apply, the carrying amount of an insurance contract at the end of each reporting period shall be the sum of:**

(a) **the fulfilment cash flows at that date, measured in accordance with paragraphs 19–27, B36–B67 and B69–B82; and**

(b) **the remaining amount of the contractual service margin at that date.**

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.

31 An entity shall recognise in profit or loss any changes in the future cash flows that, in accordance with paragraph 30, do not adjust the contractual service margin (see paragraph B68).

32 An entity shall recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of services that are provided under the contract.

Appendix A
Defined terms

This appendix is an integral part of the [draft] Standard.

contractual service margin	A component of the measurement of the **insurance contract** representing the unearned profit that the entity recognises as it provides services under the **insurance contract**.

Performance obligations to provide goods or services

B33 Paragraph 10(c) requires an entity to separate from an insurance contract a distinct performance obligation to provide goods or services. A performance obligation is defined in [draft] IFRS X *Revenue from Contracts with Customers* as a promise in a contract with a customer to transfer a good or service to the customer. Performance obligations include promises that are implied by an entity's customary business practices, published policies or specific statements if those promises create a valid expectation held by the policyholder that the entity will transfer a good or service. Performance obligations do not include activities that an entity must undertake to fulfil a contract unless the entity transfers a good or service to the policyholder as those activities occur. For example, an entity may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the tasks are performed. Hence, those promised set-up activities are not a performance obligation.

Level of measurement (paragraph 22)

B36 The expected (probability-weighted) cash flows from a portfolio of insurance contracts equals the sum of the expected cash flows of the individual contracts. Consequently, the level of aggregation for measurement should not affect the expected present values of future cash flows.

B37 However, from a practical point of view, it may be easier to make estimates in aggregate for a portfolio rather than for individual insurance contracts. For example, incurred but not reported (IBNR) estimates are typically made for a portfolio as a whole. If expenses are incurred at the portfolio level but not at an individual insurance contract level, it may be easier, and perhaps even necessary, to estimate them at an aggregate level. Accordingly, this [draft] Standard requires that entities measure an insurance contract using:

(a) expected cash flows assessed at the level of a portfolio of insurance contracts (see paragraph 22);

(b) a risk adjustment measured by incorporating diversification benefits to the extent that the entity considers those benefits in setting the amount of compensation it requires to bear risk (see paragraphs B76–B77);

(c) the contractual service margin at initial recognition at the level of a portfolio of insurance contracts, consistent with the cash flows (see paragraph 28); and

(d) the amount of contractual service margin recognised in profit or loss at a level of aggregation such that once the coverage period of the insurance contract has ended, the related contractual service margin has been fully recognised in profit or loss (see paragraph 32).

B38 However, the expected value of estimates made at the portfolio level reflects the expected value of the equivalent estimates of those amounts attributed to the individual contracts. In principle, this should be no different from making expected value estimates for individual insurance contracts and then aggregating the results for the portfolio of those contracts.

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).

Measuring the contractual service margin (paragraphs 28, 30–32 and B68)

BCA105 This Exposure Draft proposes that entities should recognise a contractual service margin that eliminates any gains at contract inception by calibrating the measurement of the insurance contract to the transaction price. This would be consistent with the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*, which allocates the transaction price to the performance obligations in the contract. As defined in Appendix A, the contractual service margin represents the unearned profit that the entity will recognise by providing services over the coverage period. Because an entity would recognise as an immediate expense any amounts that would make the contractual service margin negative, the proposals would result in an entity recognising as an increase to the liability, and as a corresponding expense, any excess of the expected present value of the future cash outflows over the expected present value of the future cash inflows, adjusted for risk. Thus, the entity would recognise an increase in the liability and a corresponding expense if the contract is onerous.

BCA106 This section discusses:

(a) the recognition in profit or loss of the contractual service margin (see paragraphs BCA109–BCA112); and

(b) the level of aggregation for the contractual service margin (see paragraph BCA113).

BCA107 The IASB's proposals that changes in the estimates of cash flows relating to future coverage or services should be offset in the contractual service margin are discussed in paragraphs BC26–BC41.

BCA108 Paragraphs BCA71–BCA73 discuss accretion of interest on the contractual service margin.

Recognition in profit or loss

BCA109 As discussed in paragraphs BC26–BC32, the IASB views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Consistently with that view, this Exposure Draft proposes that the contractual service margin:

(a) should not be negative. That requirement would mean that, when the contractual service margin has been eliminated, the entity would recognise losses, thus faithfully depicting that the entity no longer expects profit from the contract.

(b) should be recognised over the coverage period in a pattern that reflects the provision of services as required by the contract. This proposal expresses, in a more principle-based way, the proposal in the 2010 Exposure Draft. That proposal was that an entity should recognise the contractual service margin on the basis of the passage of time but, if that pattern differs significantly from the passage of time, on the basis of the expected timing of incurred claims and benefits. The 2010 Exposure Draft assumed that the incurred claims and benefits reflected the expected value of providing insurance coverage and that insurance coverage was the primary service provided under the contract.

BCA110 The IASB considered a proposal to constrain the amount of contractual service margin recognised in an accounting period in a way similar to that in the 2011 Exposure Draft *Revenue from Contracts with Customers*, but rejected it. That proposal would have constrained the cumulative amount of contractual service margin that the entity recognises to the amount to which the entity is reasonably assured to be entitled. In the IASB's view, it would be inconsistent to constrain the amount of contractual service margin on a ‘reasonably assured’ basis when that margin is measured using an expected present value basis. This Exposure Draft proposes a current measurement model and the contractual service margin depicts a current view of the unearned profits relating to coverage and other services. Consequently, it would be more appropriate to use a recognition pattern for profit that is consistent with other Standards that use a current measurement model, such as financial assets or financial liabilities measured at fair value. For financial assets or financial liabilities measured at fair value through profit or loss, the IASB believes that fair value gains or losses that occur in the period provide useful information. Thus, with the exception of day one gains that are not supported by market inputs, gains arising on financial assets or financial liabilities at fair value are not subject to any constraint on the cumulative amount recognised even though fair value gains may reverse in future periods.

BCA111 The IASB considered the view that the pattern of profit recognition for insurance contracts in which the service is primarily asset management should be similar to that for revenue contracts for asset management services that have broadly similar economic features. An investment management fee charged by a fund manager would be recognised over the period of the fund management service (if that fee is not subject to any future performance conditions). Some believe that there is little economic difference between an insurance contract that stipulates that the entity receives a share of returns on an asset pool, and an asset management fee that is calculated as a percentage of the assets under management (which therefore means that the fee is based on the performance of the pool). However, the IASB believes that there is a substantive economic difference between an entity’s share of returns on an asset pool and an investment management fee charged by a fund manager. In most cases, the fund manager does not control the underlying investments (based on the definition of control in IFRS 10 *Consolidated Financial Statements*). In addition, the fund manager would not suffer losses if there are overall losses on the pool. In contrast, the entity controls the assets of the pool and would suffer economic losses if there were overall losses on the pool. Consequently, the IASB concluded that an entity should report its economic interest in the assets in a way that is consistent with how it reports other assets in which it has an economic interest.

BCA112 Consistently with the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers*, the settlement of a liability is not considered to be a service that is provided by the entity. Thus, the recognition period for the contractual service margin is the coverage period, because this is the period over which the entity provides the coverage and other services that are promised in the insurance contract. The margin that the entity recognises for bearing risk is recognised in profit or loss as it is released from risk in both the coverage and settlement periods. In contrast, the FASB proposal would recognise the margin, which is generally equivalent to the sum of the risk adjustment and contractual service margin at initial recognition, in profit or loss over the coverage and settlement period. The FASB proposal reflects that the margin comprises a component that relates to the provision of coverage and other services and a component for bearing risk. The provision of coverage and other services occurs during the coverage period but the entity bears risk during both the coverage and settlement period.

Level of aggregation (paragraph 32)

BCA113 This Exposure Draft specifies that an entity should aggregate insurance contracts into a portfolio of insurance contracts when determining the contractual service margin. However, it does not specify the level of aggregation for recognising the contractual service margin in profit or loss. The IASB proposes that when entities recognise the contractual service margin they should use a level of aggregation that ensures that the contractual service margin is recognised in line with the pattern of services provided under the contracts to which they relate. This would mean that when the coverage period of each contract has ended, the contractual service margin relating to that contract should be fully recognised. In practice, this may result in a smaller unit of account than the portfolio that entities would generally use to manage contracts, and may require entities to group together contracts that have similar contract inception dates, coverage periods and service profiles. Another approach would be to determine the recognition of the contractual service margin at an individual contract level, but the IASB concluded that requiring that approach in all circumstances might be onerous.