STAFF PAPER

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REG IASB Meeting

Project	Insurance Contracts		
Paper topic	Cover note		
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Introduction

1. This cover note accompanies Agenda Paper 2A *Level of aggregation: application to contracts with participation features*, which outlines the application of the IASB's tentative decisions on the level of aggregation on the accounting of contracts with participation features. The staff are not asking for decisions at this meeting.

2. This cover note also provides an overview of:

   (a) the progress on the Insurance Contracts project in paragraphs 3-12;

   (b) the accounting model proposed by the IASB for contracts without participation features in Appendix A; and

   (c) the tentative decisions made in the redeliberations phase in 2014 and 2015 in Appendix B.

Summary of progress on the Insurance Contracts project

3. 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 disclosure requirements, but permits a wide range of practices and includes a 'temporary exemption'. That temporary exemption 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.

4. 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.

5. Since January 2014, the IASB has been deliberating issues raised in its third consultation document, a revised Exposure Draft issued in June 2013. The 2013 Exposure Draft 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, published in July 2010, which developed those initial views into a draft Standard.

6. The 2013 Exposure Draft sought input on only five proposals, but contained a complete draft of the proposed Standard on insurance contracts so that interested parties could consider the proposals in context. The reason for seeking limited input was to avoid revisiting issues that the IASB had previously rejected or reconsider consequences it has previously considered. 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.

7. As at the beginning of 2015, the IASB is nearing the end of its project on insurance contracts. In its deliberations, the IASB has sought to balance many diverse views and develop an approach that provides useful financial information and that can be applied in all jurisdictions that apply IFRS.

8. So far, the IASB has completed its discussions on the model for insurance contracts without participation features. The IASB also made tentative decisions on some issues that were not targeted in the 2013 Exposure Draft.

9. The IASB continues to consider and debate issues relating to its model for insurance contracts with participation features.

10. The IASB has not made any tentative decisions on the application of the general model to contracts with participation features. Instead, the IASB held several education sessions during which the IASB directed the staff in developing proposals for applications of the general model to contracts with participation features. This includes an education session in which representatives of the CFO Forum presented an alternative proposal they had put to the IASB for accounting for contracts with participation features.

11. From those education sessions, the staff have identified three key issues that the proposals for contracts with participation features must address:

    (a) If and how the contractual service margin should be adjusted to reflect changes in entity's share of underlying items;

    (b) How should the amounts in the contractual service margin be allocated to the profit or loss as the entity provides services to the policyholder; and

    (c) How to determine interest expense in profit or loss, and in particular, how to report a 'cost' based interest expense on the insurance contract.

12. The staff expect to continue discussions on contracts with participation features during the first half of 2015. After the deliberations on the model for contracts with participation features have been completed, the staff expect to consider the mandatory

effective date of the new insurance contracts Standard. Accordingly, the staff expect that the earliest date the new Standard can be published is late 2015.

Appendix A: The accounting model proposed by the IASB for contracts *without* participation features

Measurement approach

A1. 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. That approach measures an insurance contract in a way that incorporates the following:

(a) a current, unbiased estimate of the cash flows expected to fulfill the insurance contract. The estimate of cash flows reflects the perspective of the entity, provided that the estimates of any relevant market variables do not contradict the observable market prices for those variables.

(b) an adjustment for the time value of money, using discount rates that reflect the characteristics of the cash flows. The discount rates are consistent with observable current market prices for instruments with cash flow characteristics that are consistent with those of the insurance contract and exclude the effect of any factors that influence the observable market prices but that are not relevant to the cash flows of the insurance contract.

(c) an adjustment for the effects of risk and uncertainty. The risk adjustment is defined as being the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract.

(d) an amount that reflects the excess of the consideration charged for the contract over the risk-adjusted expected present value of the cash outflows expected to arise as the entity fulfils the contract (referred to as the contractual service margin). The model assumes that any excess of the consideration over the expected cash outflows is a measure of the value of the service the entity would perform in fulfilling the contract. Accordingly the contractual service margin means that the entity would not recognise that excess as an immediate gain, but would instead recognise that gain as the entity satisfied its obligation to provide service over the coverage period.

A2. Thus, the proposals in the 2013 ED represent an insurance contract as comprising both:

(a) An obligation to pay net future cash outflows, represented by the fulfilment cash flows; and

(b) An obligation to provide insurance coverage over the coverage period (ie a performance obligation), represented by the contractual service margin.

Together, the fulfilment cash flows and the contractual service margin provide an updated representation of the entity's obligations in the insurance contract.

A3. The underlying objective of this approach is to achieve a valuation of the insurance contract, including any options and guarantees embedded in the insurance contract, in a manner that is consistent with market information. However, the measurement of insurance contracts is a current expected value measurement rather than a fair value measurement. This reflects the IASB's conclusion that fair value would not be an appropriate measurement attribute for insurance contracts because insurance contracts are usually settled by satisfaction of the obligation, rather than traded. Consequently, the valuation approach proposed by the IASB takes into account the fact that an entity expects to fulfil the contracts, rather than transfer them.

A4. Nonetheless, 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 complete information about changes in estimates.

(b) 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.

(c) It means that the assets and liabilities of an entity can be measured on a consistent basis1, thus reducing accounting mismatch in comprehensive income and equity.

A5. The measurement approach in the 2013 ED reflects the IASB's view that an insurance contract combines the features of both a financial instrument and a service contract. Because the service component and the financial instrument component of the contract

[1] ie assuming that assets are measured at fair value.

are interrelated, the IASB does not propose that the components should be unbundled and accounted for separately.

A6. However, the IASB believes that the different changes in estimates relating to the service component and the financial instrument component provide different information value and thus proposes that changes in the different types of estimates included in the contractual service margin at inception are treated differently. Those differences in treatment aim to ensure as much consistency as possible between the features of each component and how that component would have been reported had it been reported separately. As a result, the IASB's model treats changes in different types of estimates after inception as follows:

(a) The entity accounts for changes in estimates relating to the service component in a way similar to the effect that would be achieved if the entity had applied the revenue recognition model to that component. As a result, changes in estimates relating to future service adjust the contractual service margin and are recognised in profit or loss when the related service is provided. Changes in estimates related to current or past periods' service would be recognised in profit or loss.

(b) The entity accounts for changes in estimates relating to the financial component in a way similar to the effect that would be achieved if the entity had applied the financial instruments model to that component. As a result, changes in estimates relating to the financial estimates are recognised in profit or loss or other comprehensive income.

Presentation approach

A7. The 2013 ED proposed a presentation approach for the statement of comprehensive income that would:

(a) align the presentation of revenue and expense with that required for other contracts with customers. This would make the financial statements of entities that issue insurance contracts easier to understand for generalist users of those financial statements.

(b) provide information about the main sources of profits for entities that issue insurance contracts.

(c) provide both a current and a cost-based view of the cost of financing an insurance contract. This would provide disaggregated information about the effects of changes in discount rates on the financial results of entities that issue insurance contracts.

A8. The information in the financial statements would be supplemented by comprehensive disclosures that would require the entity to explain:

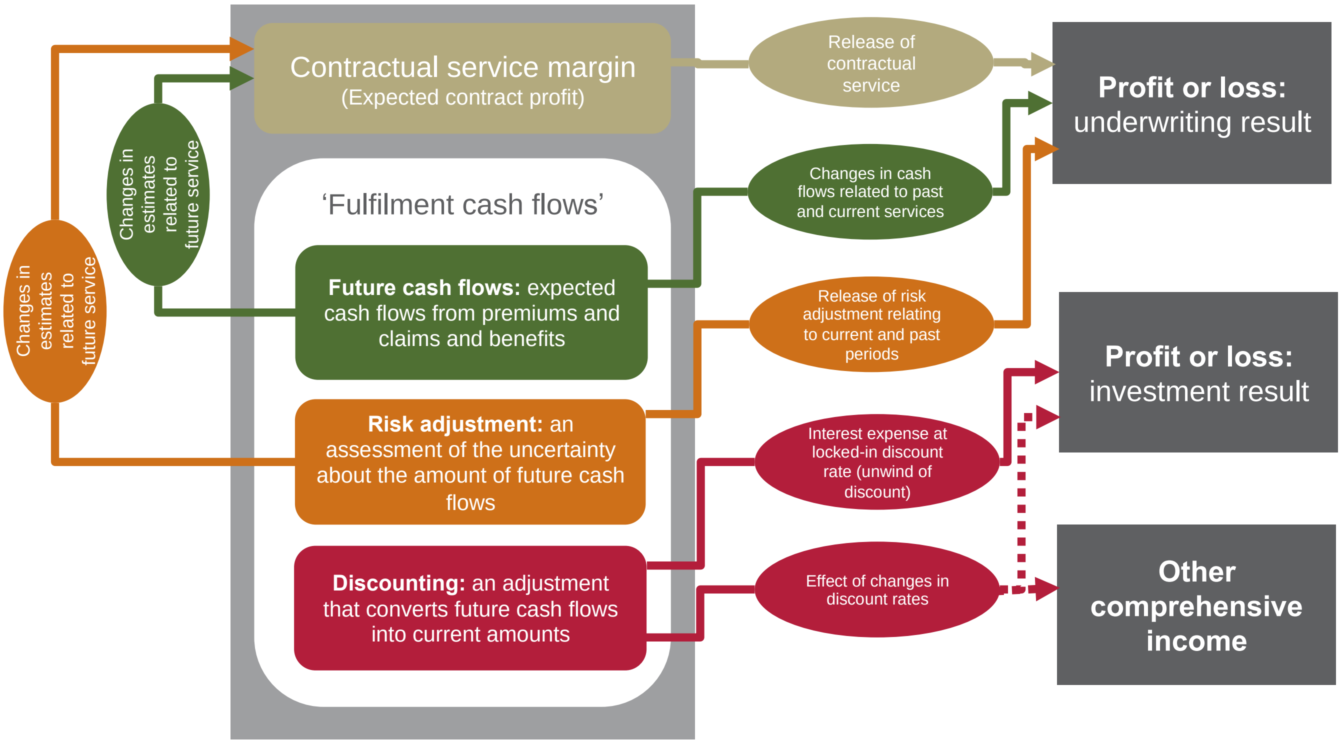
(a) the judgements needed in arriving at the amounts recognised in the financial statements;

(b) the changes in the components of the insurance contracts measurement, including a reconciliation in the amounts presented in the statement of comprehensive income; and

(c) the nature and extent of risks arising from insurance contracts.

Summary

A9. The following diagram summarises where changes in estimates are recognised and presented for contracts without participation features:


Contractual service margin
(Expected contract profit)
'Fulfilment cash flows'
Future cash flows: expected cash flows from premiums and claims and benefits
Risk adjustment: an assessment of the uncertainty about the amount of future cash flows
Discounting: an adjustment that converts future cash flows into current amounts
Changes in estimates related to future service
Changes in estimates related to future service
Release of contractual service
Changes in cash flows related to past and current services
Release of risk adjustment relating to current and past periods
Interest expense at locked-in discount rate (unwind of discount)
Effect of changes in discount rates
Profit or loss: underwriting result
Profit or loss: investment result
Other comprehensive income

Appendix B: Tentative decisions to date

The following table presents a summary of tentative decisions made in the redeliberations phase in 2014 and 2015:

	Tentative decisions	Change from 2013 Exposure Draft
1	***Targeted issue: Unlocking the contractual service margin*** (a) Differences between the current and previous estimates of the present value of expected 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 to be provided in the future. (d) An entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the contractual service margin.	The 2013 Exposure Draft would: • recognise all changes in estimates of risk adjustment immediately in profit or loss. • rebuild the contractual service margin from zero without first reversing previously recognised losses in the profit or loss.

	Tentative decisions	Change from 2013 Exposure Draft
2	***Targeted issue: Presentation of interest expense in the Statement of 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 (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	The 2013 Exposure Draft proposed that the effect of changes in discount rates should be required to be presented in OCI.

	Tentative decisions	Change from 2013 Exposure Draft
	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. (d) For contracts without participation features, an entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the contractual service margin. (e) An entity should apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to changes in accounting policy relating to the presentation of the effect of changes in discount rates.	
3	***Targeted issue: Insurance contracts revenue*** (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	The 2013 Exposure Draft did not explicitly prohibit presenting premium information in the statement of comprehensive income

	Tentative decisions	Change from 2013 Exposure Draft
	2013 Exposure Draft; and (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 Exposure Draft); (ii) a reconciliation from the premiums received in the period to the insurance contract revenue in the period (paragraph 79 of the 2013 Exposure Draft); (iii) the inputs used when determining the insurance contract revenue that is recognised in the period (paragraph 81(a) of the 2013 Exposure Draft); 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 Exposure Draft). (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.	if that information is not consistent with commonly understood notions of revenue.
4	***Targeted issue: Transition*** ***(for contracts without participation features)*** (a) an entity should apply the Standard retrospectively in accordance *with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors* unless impracticable; and (b) if retrospective application of the Standard is impracticable, an entity should apply	For contracts without participation features: • Simplified the practical expedients when retrospective application in accordance with IAS 8 is impracticable.

	Tentative decisions	Change from 2013 Exposure Draft
	the simplified approach proposed in paragraphs C5 and C6 of the 2013 Exposure Draft with the following modification: instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity should estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the beginning of the earliest period presented by the assumed release of the risk before the beginning of the earliest period presented. The assumed release of risk should be determined by reference to release of risk for similar insurance contracts that the entity issues at the beginning of the earliest period presented. (c) if the simplified approach described in paragraph (b) above is impracticable, an entity should: (i) determine the contractual service margin at the beginning of the earliest period presented as the difference between the fair value of the insurance contract at that date and the fulfilment cash flows measured at that date; and (ii) determine interest expense in profit or loss, and the related amount of other comprehensive income accumulated in equity, by estimating the discount rate at the date of initial recognition using the method in the simplified approach proposed in paragraph C6(c) and (d) the 2013 Exposure Draft. (d) for each period presented for which there are contracts that were measured in accordance with the simplified approach or the fair value approach, an entity should disclose the information proposed in paragraph C8 of the 2013 Exposure Draft (ie the disclosures for contracts for which retrospective application is	• In addition, added a way for the entity to estimate the contractual service margin on transition when both retrospeticve application nor the simplified approach are impracticable. For initial application of the new standard after implementation of IFRS 9: • Added further transition relief to permit or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts Standard.

	Tentative decisions	Change from 2013 Exposure Draft
	impracticable) separately for: (i) contracts measured using the simplified approach; and (ii) contracts measured using the fair value approach. ***(On initial application of the new insurance contracts Standard after implementation of IFRS 9* Financial Instruments*)*** (e) An entity is permitted to newly designate financial assets under the fair value option as measured at fair value through profit or loss to eliminate (or significantly reduce) an accounting mismatch according to paragraph 4.1.5 of IFRS 9; (f) An entity is required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation according to paragraph 4.1.5 of IFRS 9 no longer exists; and (g) An entity is permitted to newly designate an investment in an equity instrument as measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 and is permitted to revoke previous designations. (h) To provide further transition relief to permit or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts Standard. This reassessment would be based on the conditions for assessing the business model in paragraphs 4.1.2(a) or 4.1.2A(a) of IFRS 9 and the facts and circumstances that exist at the date of the first application of the new insurance contracts Standard.	

	Tentative decisions	Change from 2013 Exposure Draft
5	***Non-targeted issue: Level of aggregation and portfolio definition*** (a) Clarify that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract, but that in applying the Standard an entity could aggregate insurance contracts provided that it meets that objective. (b) Amend the definition of a portfolio of insurance contracts to be: "insurance contracts that provide coverage for similar risks and are managed together as a single pool". (c) Add guidance to explain that in determining the contractual service margin or loss at initial recognition, an entity should not aggregate onerous contracts with profit-making contracts. An entity should consider the facts and circumstances to determine whether a contract is onerous at initial recognition.	The definition of a portfolio in the 2013 Exposure Draft is modified to eliminate the reference to "priced similarly relative to the risk taken on". Added additional guidance and clarification
6	***Non-targeted issue: Discount rate for long-term contracts when there is little or no observable market data*** (a) Confirm the principle that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract. (b) Provide additional application guidance that, in determining those discount rates, an entity should use judgement to: (i) ensure that appropriate adjustments are made to observable inputs to	Added clarification of how the principle should be applied in determining discount rates for insurance contracts.

	Tentative decisions	Change from 2013 Exposure Draft
	accommodate any differences between observed transactions and the insurance contracts being measured. (ii) develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly any unobservable inputs should not contradict any available and relevant market data.	
7	***Non-targeted issue: Asymmetric treatment of contractual service margin between insurance contracts issued and reinsurance contracts held*** (a) After inception, an entity should recognise in profit or loss any changes in estimates of fulfilment cash flows for a reinsurance contract that an entity holds when those changes arise as a result of changes in estimates of fulfilment cash flows for an underlying direct insurance contract that are recognised immediately in profit or loss.	The 2013 Exposure Draft proposed that, for a reinsurance contract that an entity holds, all changes in estimates of fulfilment cash flows relating to future service should be recognised and offset to the contractual service margin
8	***Non-targeted issue: Allocation of the contractual service margin to the profit or loss*** ***(for contracts without participation features)*** (a) Confirm the principle in the 2013 Exposure Draft that an entity should 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 the services that are provided under an insurance contract. (b) Clarify that, for contracts without participation features, the service represented by the contractual service margin is insurance coverage that:	The 2013 Exposure Draft stated only that an entity should 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 the services that are provided under an insurance contract.

	Tentative decisions	Change from 2013 Exposure Draft
	(i) is provided on the basis of the passage of time; and (ii) reflects the expected number of contracts in force.	
9	***Non-targeted issue: Significant insurance risk*** (a) Clarify the guidance in paragraph B19 of the 2013 Exposure Draft that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis.	The 2013 Exposure Draft referred more specifically to the need for a scenario with commercial substance in which the present value of the net cash outflows can exceed the present value of the premiums.
10	***Non-targeted issue: Portfolio transfers and business combinations*** (a) Clarify the requirements for the contracts acquired through a portfolio transfer or a business combination in paragraphs 43-45 of the 2013 Exposure Draft, 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.	Clarification of requirements in the 2013 Exposure Draft to avoid difference in interpretation.
11	***Non-targeted issue: Fixed fee service contracts*** (a) Entities should be permitted, but not 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 Exposure Draft.	The 2013 Exposure Draft excluded all fixed fee service contracts from its scope.
12	***Non-targeted issue: Premium-allocation approach*** (a) Clarify that when an entity applies the premium-allocation approach to account for an insurance contract, it should recognise insurance contract revenue in profit or	The 2013 Exposure Draft required that an entity should allocate the expected premium receipts as

	Tentative decisions	Change from 2013 Exposure Draft
	loss: (i) on the basis of the passage of time; but (ii) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits. (b) When an entity applies the premium-allocation approach to contracts for which the entity: (i) discounts the liability for incurred claims; and (ii) chooses to present the effect of changes in discount rates in OCI; the interest expense in profit or loss for the liability for incurred claims should be determined using the discount rate that is locked in at the date the liability for incurred claims is recognised. This tentative decision also applies to the presentation of interest expense for any onerous contract liability that is recognised when the entity applies the premium-allocation approach.	insurance contract revenue to each accounting period in the systematic way that best reflects the transfer of services that are provided under the contract. The 2013 Exposure Draft required that interest expense on insurance liabilities should be determined using the discount rates that applied at the date that the contract was initially recognised.
13	***Non-targeted Issues that will not be addressed*** (a) In April 2014 the IASB tentatively decided not to consider in future meetings other non-targeted issues, including those relating to: (i) disclosures; (ii) combination of insurance contracts; (iii) contract boundary for specific contracts;	None

	Tentative decisions	Change from 2013 Exposure Draft
	(iv) unbundling—lapse together criteria; (v) treatment of ceding commissions; (vi) discount rate—top-down and bottom-up approaches; (vii) tax included in the measurement; and (viii) combining the contractual service margin with other comprehensive income.	