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Project	Insurance contracts		
Paper topic	Cover note		

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Introduction

1. This cover note provides an overview of:

   (a) the progress on the Insurance Contracts project in paragraphs 2-5; and

   (b) the paper for this meeting in paragraphs 6-7.

   Appendix A summarises the accounting model proposed by the IASB for contracts without participation features.

Project progress

2. The IASB is nearing the end of a long and thorough due process on its proposals for the accounting for insurance contracts. In June 2013, the IASB issued a third consultation document, a revised Exposure Draft (2013 ED). Since January 2014, the IASB has been deliberating issues raised in this third consultation round. 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.

3. So far, the IASB has completed its discussions on the model for insurance contracts without participation features. Appendix A summarises the IASB's tentative decisions to date.

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Next steps

4. In recent IASB meetings, the IASB has explored aspects of the model for insurance contracts with participation features. The staff's approach for contracts with participation features is to consider the adaptations that would be needed if the general proposals in the 2013 ED were to be applied to contracts with participation features. The staff expect to ask the IASB to make tentative decisions for the model for accounting for contracts with participation features as a whole. After evaluating that model, the staff will consider whether any form of the mirroring exception should be required.

5. The staff expect to continue discussions on contracts with participation features during the first half of 2015. The mandatory effective date of the new insurance contracts Standard will be considered after the deliberations on the model for contracts with participation features have been completed. Consequently, the earliest date the new Standard can be published is late 2015.

Papers for this meeting

6. As a result of the timetable described in paragraph 5, the earliest possible mandatory effective date of the new insurance contracts Standard will now be after 1 January 2018, the mandatory effective date of IFRS 9 *Financial Instruments* (IFRS 9). (This is because the IASB's previously stated its intention to allow a period of approximately three years between when it publishes a final Standard on insurance contracts and when that Standard comes into effect.)

7. The staff recognise that many preparers are concerned that they will be required to apply the classification and measurement requirements of IFRS 9 without the opportunity to fully evaluate the implications of the new insurance contracts Standard. Consequently, Agenda Paper 2A *Initial application of the new insurance contracts Standard after implementation of IFRS 9 Financial Instruments* asks whether the IASB wishes to consider further transition reliefs in addition to that proposed in the 2013 ED, in order to reduce the uncertainty that might arise when entities apply IFRS 9 before the initial application of the new insurance contracts Standard.

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 not traded in active markets. 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 basis[1], thus reducing accounting mismatch in comprehensive income and equity.

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

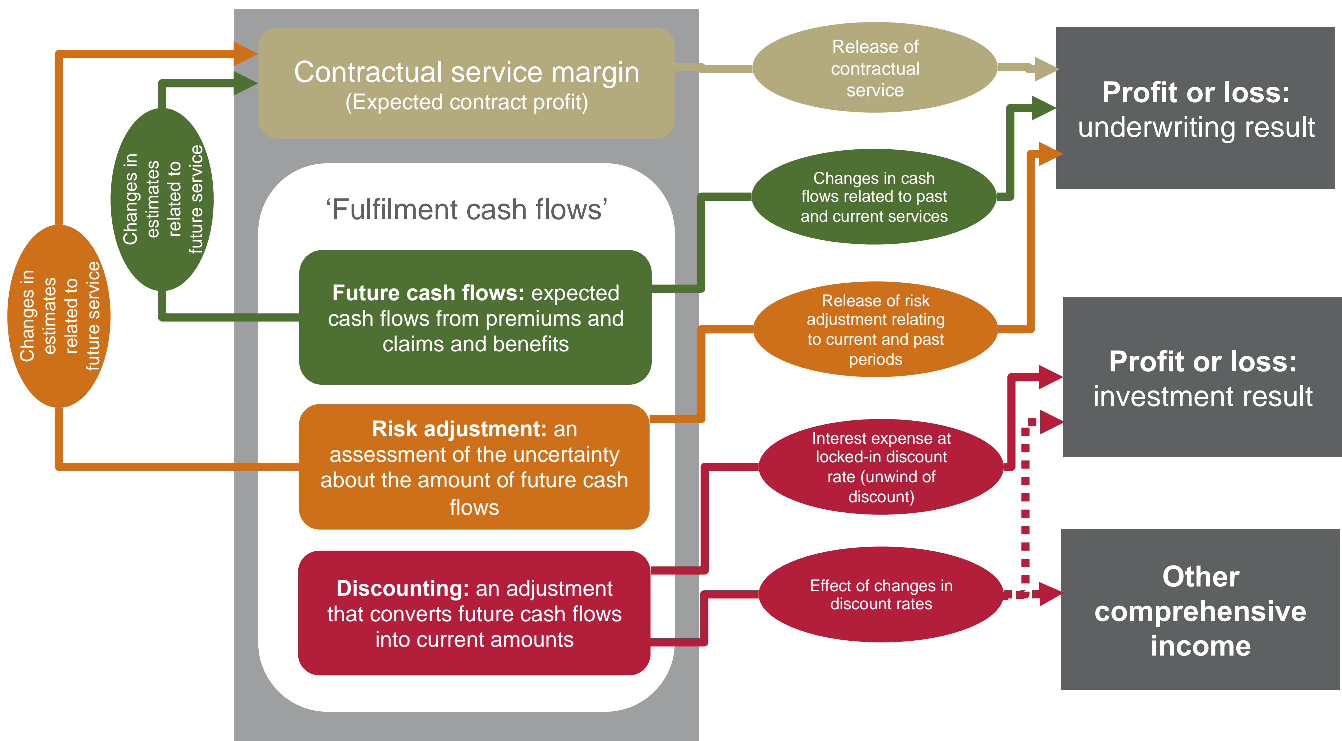
A5. The measurement approach in the 2013 ED reflects the IASB's view that an insurance contract combines the features of both a financial instrument and a service contract. Because the service component and the financial instrument component of the contract are interrelated, the IASB does not propose 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.

A7. The following diagram summarises the treatment of changes in estimates for contracts without participation features:



Presentation approach

A8. 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.

Disclosures

A9. The 2013 ED proposed 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.