IFRS

STAFF PAPER

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ASAF Meeting

Project	Insurance Contracts		
Paper topic	IASB staff response to the AASB & NZASB staff paper on the disclosure of discount rate impacts on the Contractual Service Margin recognition – non-participating insurance contracts		
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Purpose of the paper

1. In Agenda Paper 1E *Disclosure of discount rate impacts and accretion of interest on the Contractual Service Margin (CSM) – non-participating insurance contracts*, the staff of the Australian Accounting Standards Board (AASB) and the New Zealand Accounting Standards Board (NZASB) recommend an approach, for insurance contracts without participation features, that would:

   (a) confirm the IASB's tentative decision to allow an accounting policy choice to present the effect of changes in discount rates in profit or loss or other comprehensive income (OCI); and

   (b) when an entity has selected as its accounting policy choice to present the effects of changes in discount rates in profit or loss, that entity shall:

      (i) apply current discount rates (rather than locked-in discount rates) for accreting interest on the CSM and for measuring the present value of future cash flows that adjust the CSM; and

      (ii) disclose the effect of changes in discount rates between the beginning and end of the reporting period (rather than the effect of changes in discount rates between the date of inception and the end of the reporting period) .

2. However, the AASB and NZASB staff would not require that current discount rates be applied in accreting the CSM or in remeasuring the CSM for changes in estimates of future cash flows relating to future coverage if an entity chose an accounting policy that would present the effect of changes in discount rates in OCI.

3. In this paper the IASB staff responds to the main arguments in Agenda Paper 1E and explain the IASB's rationale for tentative decisions that:

   (a) An entity should choose as its accounting policy to present the changes of discount rates in profit or loss or other comprehensive income (OCI). That accounting policy choice affects the presentation in statement of comprehensive income only and does not affect the measurement of the liability on the balance sheet.

   (b) The discount rate at inception is used to accrete interest on the CSM and in measuring the adjustments to the CSM.

   (c) An entity should disclose the effect of changes in discount rates between the date of inception and the end of the reporting period, to allow users to compare the results between entities making different accounting policy choices.

4. This paper has not been reviewed by the IASB and does not represent the views of the IASB.

Background information

Contractual service margin

5. The IASB's model would measure an insurance contract using a current value approach, which at inception includes an amount (referred to as the contractual service margin) that reflects the excess of the consideration charged for the contract over the risk-adjusted expected present value of the cash outflows that will arise as the entity fulfils the contract. The contractual service margin is a measure of the service the entity would provide in fulfilling the contract.

6. Subsequently, the contractual service margin is adjusted as follows:

   (a) Favourable and unfavourable differences between current and previous estimates of the fulfilment cash flows that relate to future coverage (determined using the locked in rate) are absorbed in the contractual service margin, subject to the contractual service margin not being negative.

   (b) An allocation of the contractual service margin is recognised in profit or loss as the entity provides service under the insurance contract. The IASB has concluded that the service in a contract without participation features is the provision of insurance coverage, which is provided on the basis of the passage of time. (This issue is discussed in ASAF Agenda Papers 1B and 1C).

   (c) Interest is accreted on the contractual service margin, using the rate locked in at inception of the contract.

Accounting policy choice

7. The IASB has tentatively decided that an entity should choose its accounting policy to present the effect of changes of discount rates in profit or loss or OCI. In reaching this conclusion, the IASB sought to balance the sometimes competing demands of understandability and comparability by adopting an approach that:

   (a) continues to acknowledge that, when measurement inconsistencies do not result in a lack of faithful representation, it could be appropriate to measure financial assets at FVOCI or amortised cost and present the effect of changes in discount rates on the measurement of insurance contracts in OCI.

   (b) allows entities to avoid accounting mismatches when such mismatches would result in financial statements that do not faithfully represent the entity's financial position and performance.

   (c) allows entities to avoid the costs and complexity of using OCI when the benefits of doing so do not outweigh those costs (permitting entities to present interest expense using current rate in profit or loss would eliminate the need for additional calculations to derive separate amounts in profit or loss and in OCI).

8. However, to address concerns about comparability between entities choosing different accounting policies, the IASB tentatively decided that it would require disclosures that ensure that the information sought by users of financial statements would be provided in a way that allows comparison, regardless of whether the effect of changes in discount rates is provided in profit or loss or in OCI. Accordingly, the IASB tentatively decided that entities should disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum:

   (a) the amount of interest accretion of the fulfilment cash flows determined using current discount rates;

   (b) the effect on the measurement of insurance contracts of changes in discount rates in the period; and

   (c) the difference between the present value of changes in expected cash flows that adjust the CSM in a reporting period, measured using discount rates that applied on initial recognition of insurance contracts, and when measured at current rates.

   The IASB also tentatively decided that entities should apply the same accounting policy choice to groups of similar contracts, considering the portfolio in which the contract is included, the assets that the entity holds and how those assets are accounted.

Implications of the IASB's June 2015 discussions

9. The IASB staff notes that the papers for the June 2015 IASB meeting ask the IASB to make tentative decisions for contracts with participation features. In particular, the IASB staff asks whether the IASB should modify its general measurement model for accounting for insurance contracts so that, for such contracts, changes in the estimate of the variable fee for service are adjusted in the contractual service margin.

10. If the IASB tentatively decides to modify the general model as described in paragraph 9, the IASB staff plan to consider whether the tentative decisions for the general model should be modified to increase the consistency between the general model and this variable fee approach. In particular, the IASB staff notes that under the variable fee approach, the CSM is in effect remeasured and accreted at current discount rates. Accordingly, the IASB staff would expect to consider if the CSM should be remeasured using current discount rates for each reporting period after initial recognition. However, the IASB staff also note that such an approach would remeasure all aspects of the CSM consistently using current discount rates, including:

    (a) the opening balance of the CSM so that it reflects changes in discount rates since the previous period;

    (b) all adjustments to the CSM; and

    (c) interest accreted on the CSM.

11. There are likely to be significant differences between the determination of the closing balance of the CSM using the remeasurement approach using current rates discussed in paragraph 10 and using the rate at inception discussed in paragraph 3. The IASB staff observe that providing an accounting policy choice between the two approaches would reduce the ability of users to compare the contracts accounted for under the different accounting policy choice elections.

IASB staff response

12. The table below sets out the IASB staff response to the key arguments in Agenda Paper 1E. This table is not intended to provide a response to every argument that is set out in agenda paper 1E.

	Issue	Ref[1]	Argument in the AASB/NZASB paper	IASB staff response
1	Both components of insurance liabilities should be measured using current rates for entities with a current value measurement model to provide useful information.	4,[35-36]	Use of contract inception-date discount rates to accrete interest on the CSM and for unlocking the CSM (in relation to changes in the present value of expected cash flows due to changes in expected timing and expected amounts to be paid) in what is otherwise a current value measurement model would not result in useful information. In the context of IFRS 15 *Revenue from Contracts with Customers*, the AASB and NZASB staff acknowledge that, when adjusting the promised amount of consideration for a significant financing component, the entity is required to use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception [IFRS 15, paragraph 64]. However,	The IASB's tentative decision reflects the view that a locked-in rate is conceptually correct, because the interest accretion should reflect only the time difference between the initial recognition of the contract and the time when the service is provided. It does not reflect the current price that the entity would charge for the service at the reporting date. Furthermore, the staff observes that one of the reasons for adjusting changes in the estimates in the CSM is to increase consistency between the determination of the CSM on day one and subsequently. At initial recognition, the entity determines the CSM taking into account the time value of money at inception. Accordingly, to be consistent with the CSM at initial recognition, the entity should unlock the contractual service margin for changes in estimates of cash flows using the discount rate at inception. This would result in the contractual service margin implicitly reflecting the time value of money estimated at inception.

[1] Those numbers relate to the relevant paragraphs in the Agenda Paper 1E for this meeting prepared by the AASB & NZASB staff.

	Issue	Ref[1]	Argument in the AASB/NZASB paper	IASB staff response
			the AASB and NZASB staff consider that this is not relevant in a current value measurement environment and, if interest is to be accreted to the CSM, it should be accreted using a current discount rate. We consider that the better analogy among IFRS is to the liability measurement under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which requires provisions and changes in provisions to be measured using entirely current inputs.	In addition, the staff observes that using the rate at inception treats the CSM similarly to a pre-payment for non-insurance services in IFRS 15. In accordance with IFRS 15, an entity would accrete interest using the rate at the inception of the contract. Consequently, using rate at inception would improve the comparability of profits for services delivered for insurance and non-insurance contracts. It would also be consistent with the premium allocation approach, which in effect uses locked-in rates, consistently with IFRS 15. The IASB staff does not find the analogy to IAS 37 persuasive because when there are changes in cash flows relating to the future obligation, the impact of those cash flows are recognised immediately in profit or loss. In contrast, when there are changes in cash flows relating to future service both IFRS 15 and the insurance model (through adjusting the CSM) would recognise those changes in the future where those services are provided. As discussed in paragraph 10, if the IASB decides to adopt the variable fee approach, the IASB staff plan to consider whether the measurement of the CSM should be made more consistent between the variable fee approach and the general model.
2	Operational complexity	14	The AASB and NZASB staff are concerned about the difficulties associated with tracking changes in discount rates of contracts from	The IASB staff notes that the complexity of applying locked-in discount rates is needed to achieve the economic depiction of the CSM as discussed in the row above.

Issue	Ref[1]	Argument in the AASB/NZASB paper	IASB staff response
		historical rates to achieve the proposed outcomes identified in [ASAF Agenda paper 1F] paragraph 13 above. The AASB and NZASB noted that these difficulties compounded their concerns about the potential for confusing information to be provided to users. This is based on a view that there would be a lack of consistency in the ways in which different entities would identify portfolios of contracts relating to particular inception-date discount rates. The AASB and NZASB took the view that the IASB would need to provide another layer of guidance on determining portfolios by inception-date discount rate, which may not be effective in achieving consistency among different entities. This is because a requirement to identify portfolios of contracts with the same or similar inception-date discount rates introduces a level of complexity that seems likely to lead to different decisions being made about the scope of those portfolios. Many entities are likely to resort to considering discount rate changes each reporting period, which will be impacted by the timing of their year-ends. Others might seek to monitor each time discount rates change in each month or each quarter as the basis for portfolios of contracts with the same or similar inception-	Furthermore, the IASB staff notes that if the current rates were used to adjust and accrete the CSM were applied also to the entities that chose to present the effects of discount rates in OCI, those entities would need to do additional calculations to present the changes in the discount rates in OCI for those arising for the CSM. That would increase the complexity for such entities. The IASB staff note that the AASB and NZASB proposals would address this additional complexity for entities that chose to present the effects of discount rates in OCI by allowing different measurements of the insurance contract depending on the accounting policy for presenting the effect of changes in discount rate. However, the IASB staff view is that the proposal recommended for the AASB and NZASB will increase the complexity for the users because the measurement of the CSM, and therefore the insurance liability, might no longer be comparable within an entity (and also between entities). In contrast, the IASB's proposal for an accounting policy choice on the presentation of the effect of changes in discount rate does not affect the measurement of the CSM, and therefore the measurement of the liability. Finally, the IASB staff are unclear on the method of applying current rates that the AASB/NZASB are recommending and notes that there are two methods both

Issue	Ref[1]	Argument in the AASB/NZASB paper	IASB staff response
		date discount rates.	with differing complexity: (a) the present value of cash flows would be adjusted against the margin at the rate applicable when there is a change and the accretion of the margin would be at the current rate. Consequently, the closing balance of the margin would be a reflection of cash flows discounted using different discount rates which staff thinks is difficult to explain. In addition, because the effects of some changes in discount rates are reflected in the CSM, this could result in the loss of disaggregated information about underwriting and investing results. (b) entities would need to remeasure the opening balance of the contractual service margin so that it reflects changes in discount rates since the previous period. However, the opening balance of the contractual service margin cannot be characterised as an expected cash flow. Accordingly 'remeasuring' the CSM as if it were a cash flow may not be intuitive as the CSM is merely a balance. In addition, under this method some of the effect of the changes in discount rates would adjust the CSM.
One of the proposed disclosures lacks meaning for entities with a current value	3	Disclosure of the impact of differences between contract inception-date discount rates and current discount rates in OCI under the profit or loss accounting policy choice would not be meaningful. There are essentially two bases for this concern: (a) the amount itself does not relate to an event of the period, and therefore has	The IASB staff notes that this disclosure would allow users of financial statements to compare contracts applying different accounting policy choices for the presentation of the effect of changes in discount rates by allowing users to understand the components of interest expense. The IASB staff expects that this disclosure would not be onerous for preparers because the amounts that adjust the margin are determined using the rate at inception.

Issue	Ref[1]	Argument in the AASB/NZASB paper	IASB staff response
measurement model		no relevance in a current value model; and (b) in the context of all but the most simple of insurance businesses, the amount reported in any given period would be the net result of multiple gains and losses across many periods.	The IASB staff notes that other IFRSs, for example IAS 40 *Investment Properties* also require additional disclosures to reduce the difficulties for users seeking to compare similar economic transactions accounted for using different accounting policies. In the IASB's staff's view, the disclosures recommended by the AASB and NZASB staff would **not** allow the user to compare contracts for which different accounting policy choices has been applied. The accounting policy choice proposed by the AASB and NZASB staff would affect the measurement of the CSM, and the total liability. Accordingly, this would increase the lack of comparability between contracts for which different accounting policy choices has been applied (discussed in the row above). The AASB and NZASB staff recommended disclosures would not provide information for the users to reconcile the CSM, and the total liability, applying the different recommended measurement accounting policy elections.

Question for ASAF members
Do you have any comments on the IASB staff analysis of the main arguments in agenda paper 1E?