STAFF PAPER

June 2015

IASB Meeting

Project	**Insurance Contracts**
Paper topic	Application of the general model to contracts with participation features

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Purpose of this paper

1. This paper provides a reminder of the IASB's tentative decisions to date on the measurement of insurance contracts. This paper is provided for context, and does not ask the IASB for decisions.

General measurement model for insurance contracts

2. The IASB is considering the accounting for contracts with participation features in the context of adaptations that might be needed to its general measurement approach. That general measurement approach had been developed taking into account all features of insurance contracts, including the presence of cash flows that vary with returns on assets.[1]

3. Paragraphs 4-10 summarise the general model, reflecting the proposals in the IASB's 2013 Exposure Draft *Insurance Contracts* (the 2013 ED), modified by the IASB's tentative decisions during the redeliberations on the 2013 ED. Paragraphs 11-13 describe what the general model depicts.

At initial recognition

4. The IASB's approach measures insurance contracts using a current value approach which incorporates, at initial recognition:

[1] For simplicity, this paper refers to returns on assets. However, the analysis in this paper could be extended to refer to groups of specified assets and liabilities, or a pool of assets and liabilities including those that reflect other factors such as mortality gains and losses.

(a) A current, unbiased estimate of the cash flows expected to fulfil 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. It includes all the cash inflows and cash outflows that relate directly to the fulfilment of the insurance contract.[2] Investment returns on assets held by the insurer are excluded from the estimate of cash flows, and those investments are recognised, measured and presented separately.[3]

(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. Thus, the discount rates 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. Accordingly, to the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depend wholly or partly on asset returns, the characteristics of the liability reflect that dependence.[4]

(c) An adjustment for the effects of risk and uncertainty.[5] 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.[6] The risk adjustment reflects all the risks associated with the insurance contract, other than those reflected through the use of market consistent inputs. It does not reflect the risks that do not arise from the insurance contract, such as investment risk relating to assets that an entity holds, (except when the investment risk affects the amounts payable to policyholders),

[2] Paragraph 22 of the 2013 ED.

[3] Paragraph B67(a) of the 2013 ED. However, as noted in paragraph B67(a), the measurement of an insurance contract may be affected by the cash flows, if any, that depend on the investment returns.

4 Paragraphs 25 and 26 of the 2013 ED.

5 Paragraph 27 of the 2013 ED.

6 Appendix A of the 2013 ED

asset-liability mismatch risk or general operational risk that relates to future transactions.[7]

(d) 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. Accordingly, the entity would not recognise the excess as an immediate gain, but would instead recognise that gain over time as the entity satisfies its obligation to provide service over the coverage period. If the consideration charged for the contract is less than the risk-adjusted expected present value of the cash flows the entity expects to arise as it fulfils the contract, the entity recognises an immediate loss in profit or loss.

5. Thus, at initial recognition, the IASB's approach represents an insurance contract as comprising both:

(a) An obligation to pay net future cash outflows, represented in 3(a) to 3(c), and referred to collectively as the fulfilment cash flows;[8] and

(b) An obligation to provide insurance coverage over the coverage period, 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 arising from the insurance contract.

Subsequent measurement

6. After initial recognition, the measurement of the insurance contract is adjusted as follows:

[7] Paragraphs B78 of the 2013 ED.

[8] The 2013 ED defined the fulfilment cash flows as "An explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment."

(a) The entity remeasures the fulfilment cash flows (ie the risk-adjusted present value of the cash flows expected to arise as the entity fulfils the contract).

(b) The contractual service margin is adjusted as follows:

(i) 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.

(ii) 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.

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

7. The remaining effects of remeasuring the fulfilment cash flows are recognised in the statement of comprehensive income. In particular:

(a) Changes in estimates relating to the financial components, including the effects of changes in discount rates, are recognised in profit or loss or other comprehensive income in the period in which the change occurs.

(b) Changes in estimates relating to the current period and past period services are recognised in profit or loss.

8. In addition, because the assets the entity holds are not part of the insurance contract, the gains and losses on those assets are accounted for in accordance with other applicable IFRSs. The difference between changes in value of assets and liabilities portrays the entity’s net exposure that arises from the change in economic circumstances.

What the general model portrays

9. The objective of the IASB’s general model is to achieve a valuation of the insurance contract, including any options and guarantees embedded in that

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 IASB's valuation approach takes into account the fact that an entity expects to fulfil the contracts, rather than transfer them. In other words, the approach reflects the IASB's view that an insurance contract combines the features of both a financial instrument and a service contract.

10. Because the service component and the financial instrument component of the contract are interrelated, the model does not propose that the components should be unbundled and accounted for separately. However, the IASB's aim is to achieve consistency, where appropriate, between (i) the reporting for the features of each component under this proposed Standard and (ii) the reporting for that component had it been recognised and measured separately. As a result, and consistently with other IFRSs, the IASB treats changes in estimates relating to the service component differently to changes in estimates relating to the financial instrument component, reflecting their different information values. Accordingly:

    (a) Changes in estimates relating to future service are recognised to achieve a similar outcome as would be achieved if the entity had applied IFRS 15 *Revenue from Contracts with Customers* to that component. Thus, those changes are recognised as an adjustment to the contractual service margin and affect profit or loss in the period in which the future service is provided, as described in paragraph 7(a). Discretionary changes in the proportion of asset returns that an entity expects to pay to policyholders relate to future service; and

    (b) Changes in estimates relating to the financial component are recognised to achieve a similar outcome as 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 components, including the effects of changes in discount rates, are recognised in profit or loss or other comprehensive income in the period in which the change occurs.

Recognising changes in discount rates in the statement of comprehensive income (rather than as an adjustment to the contractual service margin) also reduces accounting mismatches between insurance contracts and the assets that an entity holds. This is because the effect of changes in discount rates for both items would be recognised in the statement of comprehensive income.

11. In this way, the IASB's general measurement approach reports the sources of profit for insurance activities in the statement of comprehensive income for each period as follows:

    (a) The underwriting result arises from both the release of risk and the allocation to profit or loss of the contractual service margin (on the basis of the passage of time).

    (b) The investing result (which also reflects the entity's investing activity) arises as the difference between (i) the gains and losses on the entity's investment portfolio (ie the returns on the investment portfolio), which would be recognised in the statement of comprehensive income according to other applicable IFRS and (ii) the payments that the entity makes to the policyholder out of those returns.

12. In other words, applying the IASB's general measurement approach, the entity's investment portfolio would be accounted for in the same way as a standalone investment that the entity owns and controls. This approach reflects the fact that, in most cases, the entity has legal title for the investment portfolio, and has a separate obligation to the policyholder that arises from the insurance contract.

13. Consistent with that approach, the financial statements of the entity will reflect the net investment return reflecting the entity's exposure to changes in the value of the investment portfolio. The gains and losses that the entity passes to the policyholder through the participation mechanism would be recognised as changes in the insurance contract liability, and offset the gains and losses recognised on the entity's investment portfolio. The net investment returns would portray the net effect of the entity's exposure to changes in economic variables.