STAFF PAPER

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ASAF Meeting

Project	Insurance Contracts		
Paper topic	IASB staff response to the ASBJ paper on the Use of OCI for Presentation of Unearned Profits		
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Purpose of the paper

1. In agenda paper 6A *Insurance Contracts: Use of OCI for Presentation of Unearned Profits*, the Accounting Standards Board of Japan (ASBJ) proposes that the contractual service margin of an insurance contract should be presented in 'AOCI' (ie the cumulative balance of other comprehensive income within equity). In contrast, the IASB proposes a model in which the contractual service margin is an integral part of the measurement of the insurance contracts, and would therefore be presented in the liability section of the statement of financial position. In this paper the IASB staff responds to the main arguments in agenda paper 6A. This paper has not been reviewed by the IASB and does not represent the views of the IASB.

Background information

2. The IASB is in the final stages of developing a model for the accounting for insurance contracts. That model has been the subject of extensive due process. Most recently, the IASB proposals were set out in the 2013 Exposure Draft *Insurance Contracts*. That model proposes that an entity should measure an insurance contract at initial recognition and subsequently as the sum of:

   (a) The fulfilment cash flows, which is the present value of all expected cash inflows and outflows, adjusted for risk; and

   (b) The contractual service margin (CSM) that:

(i) at initial recognition of the insurance contract is calculated as the difference between the present value of expected cash inflows and cash outflows adjusted for risk[1]. Consequently, it reflects the part of the price an entity charged for the services to be provided under the insurance contract.

(ii) subsequently is recognised in profit or loss according to the pattern of services provided under the insurance contract.

3. The IASB proposes to present that sum (ie the fulfilment cash flows plus the CSM) as a contract liability or a contract asset. Accordingly,

(a) A contract liability arises, if the measure of the remaining obligations exceeds the measure of the remaining rights;

(b) A contract asset arises, if the measure of the remaining rights exceeds the measure of the remaining obligations.

4. In agenda paper 6A, the ASBJ disagrees that an entity should present CSM as part of the insurance contract. Instead, the ASBJ paper proposes that an entity should present the CSM in 'AOCI', ie in the cumulative balance of other comprehensive income within equity. The CSM would then be reclassified to profit or loss over the coverage period in a rational way that best reflects the remaining transfer of services that are provided under the contract.

[1] Provided that the contractual service margin must not be negative.

IASB staff response

5. The table below sets out the IASB staff response to the key arguments in agenda paper 6A. This table is not intended to provide a response to every argument that is set out in agenda paper 6A.

	Issue	Ref[2]	Argument in the ASBJ paper	IASB staff response
	Statement of financial position			
1	Is presenting the CSM in liabilities appropriate?	12-13	The ASBJ paper states that the CSM does not meet the definition of a liability, and hence should not be recognised as a liability. This is because an entity does not have an obligation to transfer unearned profits to third parties.	The existing *Conceptual Framework* defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.' In addition, as part of the project to review the *Conceptual Framework*, the IASB tentatively decided that a liability should be defined as 'a present obligation of the entity to transfer an economic resource as a result of past events.' Under the model proposed by the IASB, the CSM does not represent an obligation to transfer unearned profits. Rather, it is one component of the measurement of the liability for the insurance contract. The resulting measure depicts the obligations to transfer economic resources created by the insurance contract as a whole. Accordingly, the insurance contract as a whole meets the definition of a liability in the existing and proposed versions of the *Conceptual Framework*.

[2] Those numbers relate to the relevant paragraphs in the agenda paper 6A for this meeting prepared by the ASBJ.

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2	Consistency with IFRS 15	42-44	The ASBJ paper states that the ASBJ does not believe that the CSM reported as part of the insurance liability is consistent with the requirements of the IFRS 15 *Revenue from Contracts with Customers*. This is because the ASBJ believes that: • IFRS 15 does not require the use of current measure for the purpose of reporting an entity's financial position, and unearned profits are not recognised in the statement of financial position. • Under IFRS 15, measurement bases of contracts from customers are determined solely in light of the customer's point of view; thus the portion of unearned profits would not be presented in the statement of financial position.	At inception, including the CSM in the measurement of the insurance liability is consistent with using a cost-based measurement of the liability according to IFRS 15. The revenue from contracts with customers is measured at the total consideration, which incorporates the profit the entity has charged for the contract. Similarly, including a CSM in the measurement of the insurance contract ensures that the contract is measured at the transaction price. In both IFRS 15 and the new insurance contracts Standard, that transaction price is the amount the entity charged the customer, and therefore is not solely the customer's point of view. Requiring a current measurement approach after inception does not alter that conclusion. However, the staff also notes that, after inception, the adjustment of the CSM to reflect changes in estimates relating to future service has the effect of 'locking' the overall insurance contract measurement to the original transaction price, which is also consistent with the proposals in IFRS 15.
	Other Comprehensive Income (OCI)			
3	Use of OCI on initial recognition	18	The ASBJ paper views OCI as a link that is used when the measurements that are relevant from the perspective of reporting the entity's *financial position* differ from the measurements that are relevant from the perspective of reporting the entity's *financial*	Both IAS 1 *Presentation of Financial Statements* and the forthcoming *Conceptual Framework* ED stipulate that profit or loss and OCI are sources of information about performance for the period. Consequently, reporting the CSM in OCI (or profit or loss) at initial recognition of the insurance contract could only be appropriate if the CSM on

Issue	Ref[2]	Argument in the ASBJ paper	IASB staff response
		performance.[3] Two different measurement bases could be used for the same item, and thus OCI should be used as the linkage factor when: • it is relevant from the perspective of reporting the entity's *financial position* to remeasure assets and liabilities that are exposed to certain risks by using the information updated at the reporting date; but • such remeasurements are not relevant from the perspective of reporting the entity's *financial performance.*	initial recognition met the definition of income. However, the IASB concluded that CSM on initial recognition of the insurance contract is not income because the entity has not provided any services under the contract at initial recognition. Rather, it represents part of the measurement of the liability, representing the obligation to provide service under the contract. Furthermore, even if CSM met the definition of an income, under the forthcoming *Conceptual Framework* ED: • there is a presumption that all items of income or expense should be reported in profit or loss; • items of income or expense can only be reported in OCI if they arise from *remeasurements* and if doing so would enhance the relevance of profit or loss for the period.
	27-29	The ASBJ paper acknowledges that CSM arises at initial recognition of the insurance contract rather than remeasurement of that contract. However: • the ASBJ believes that the proposed insurance contracts standard is different in nature from other standards in that measuring cash inflows and outflows from the entity's viewpoint is considered appropriate for reporting the entity's	Therefore, reporting CSM in OCI would not be appropriate under the *Conceptual Framework* ED because it arises on initial recognition, not as subsequent remeasurement. In the staff's view, the use of cash inflows and outflows from the entity's viewpoint for measuring the insurance contract does not alter that conclusion.

[3] This view was presented in more detail in the ASBJ paper "Profit or Loss / OCI and measurement", which was discussed at the December 2013 ASAF meeting.

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			financial position but not financial performance; • the ASBJ suspects that IASB does not use OCI to present the CSM at initial recognition because IFRS generally use transaction price as a measurement basis on initial recognition and there has been no extensive previous debate regarding the use of OCI on initial recognition; and • the ASBJ believes that presenting the CSM in OCI on initial recognition is consistent with both the ASBJ's view of the OCI and the July 2014 IASB's tentative decisions in the *Conceptual Framework* project because the need to use two measurement bases can arise on initial recognition.	
4	Presentation of the CSM as AOCI	30-34	The ASBJ paper proposes that the CSM should be part of equity (specifically AOCI) at initial recognition and subsequently until it is included in profit or loss. That would result in an increase in equity immediately after recognising any contracts expected to be profitable. Consequently: • It would decrease the debt/equity ratio and send misleading information to users of financial statements.	The staff believe that incorporating the CSM in equity is inconsistent with IFRSs, which define equity as the equity holders' residual interest at the reporting date. As noted in item 3, the CSM is not attributable to equity holders at the reporting date because it has not yet been earned. Furthermore, as explained in item 3 above, income and expenses included in OCI for the period reflect the entity's performance for the period. Consequently, the cumulative balance of OCI (ie AOCI) is part of equity, and should not be excluded for the purposes of debt/equity ratio

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			• It would be inconsistent with the requirements of prudential regulation for calculating equity without future profits. As a consequence of the above, the ASBJ paper further proposes that AOCI would be a separate part of equity that is classified outside of the category attributable to owners of an entity. This would ensure that users would exclude AOCI when calculating equity for the purposes of the debt/equity ratio and for prudential reporting purposes.	calculations. The staff notes that prudential regulators have a different objective to that of other financial statement users, and may as a consequence, determine a different objective for equity. Therefore the treatment of equity for prudential reporting purposes should not be the basis for the accounting treatment of equity.
	Profit or loss statement			
5	Amounts reported in profit or loss	18a)ii 18b) 21	The ASBJ paper proposes that profit or loss should result from the change in net assets during a period, excluding those changes that result from transactions with owners in their capacity as owners. This is further described as follows: 1) Profit or loss should represent an all-inclusive measure of irreversible outcomes of an entity's business activities in a certain period. 2) The measurement basis considered to be relevant from the perspective of reporting the entity's financial performance should be determined by carrying over the balance of	The staff note that the view of profit or loss as the irreversible outcome of the entity's business activities in the period is inconsistent with the forthcoming *Conceptual Framework* ED that describes profit or loss as the primary source of information about the entity's performance for the period. Furthermore, applying such a notion in the context of insurance contracts may be difficult in practice because it is uncertain when any gains or losses would be recognised while the insurance contract is still in-force. For in-force contracts, some risks, though reduced, are still present and hence the gains or losses would not be irreversible until all risks are fully eliminated. In addition, the approach proposed by the ASBJ paper is also inconsistent with other IFRSs (for example IFRS 9

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		previous periods (starting with nil at initial recognition), as appropriately adjusted through additions and subtractions in subsequent periods rather than applying a particular measurement basis (such as fair value).	*Financial Instruments*) that require an entity to recognise in profit or loss (for certain financial assets) gains and losses that may reverse over time.

Question for ASAF members
Do you agree with the IASB staff analysis of the main arguments in agenda paper 6A?