STAFF PAPER

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Project	**Insurance contracts**
Paper topic	Should the new insurance contracts Standard retain the mirroring approach?

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Purpose of this paper

1. The purpose of this paper is to ask the Board if the mirroring approach to the measurement and presentation of contracts that meet specified criteria, which was proposed in the 2013 Exposure Draft *Insurance Contracts* ('the ED'), should be retained in the proposed insurance contracts Standard. The mirroring approach would apply in accordance with the ED when a contract requires an entity to hold underlying items and specifies a link to returns on those underlying items.

Staff recommendations

2. The staff recommend that the mirroring approach is not permitted or required in the proposed insurance contracts Standard

Structure of the paper

3. This paper is structured as follows:
   (a) Description of the mirroring approach proposed in the ED (paragraphs 4 to 7);
   (b) Constituents' views on the mirroring approach (paragraphs 8 to14);
   (c) Staff analysis, in particular:

(i) Understanding the factors relevant to mutual entities (paragraphs 15 to 28);

(ii) Presentation formats for mutual entities (paragraphs 29 to 31); and

(d) Staff recommendations (paragraph 32).

The mirroring approach proposed in the 2013 ED

4. The ED proposed a method termed the 'mirroring approach' for the measurement and presentation of contracts that require an entity to hold underlying items and that specify a link to returns on those underlying items. The essence of the mirroring approach is that, to the extent that an entity expects to settle fulfilment cash flows payable to policyholders with assets or other underlying items[1] that it holds, the entity would measure those fulfilment cash flows in the same way as the underlying items. Similarly, the ED proposed that an entity would recognise changes in fulfilment cash flows that are subject to the mirroring approach (those that are expected to vary directly with returns on underlying items) in profit or loss or other comprehensive income (OCI) on the same basis as the recognition of changes in the value of the underlying items.

5. Mirroring eliminates accounting mismatches between the cash flows from an insurance contract and underlying items when the terms of the contract mean that the entity will not suffer any economic mismatches. However, not all cash flows in an insurance contract will vary directly with returns on underlying items. To apply the mirroring approach, an entity would identify and apply different measurement bases to:

(a) cash flows that varied directly with underlying items, which would be measured on the same basis as the underlying items; as distinct from

(b) all other cash flows, which would be measured using the general approach in the ED.

[1] Examples of underlying items include specified assets and liabilities, an underlying pool of insurance contracts, and the assets and liabilities of an entity as a whole

Some refer to the separation of cash flows in this way as bifurcating, or decomposing, the cash flows.

6. An entity would present changes in the cash flows that varied directly with underlying items on the same bases as the presentation of the underlying items. However, there are differences in the presentation of changes in the other cash flows, as follows:

   (a) changes in cash flows that vary indirectly with underlying items would be presented in profit or loss; and

   (b) changes in cash flows that are fixed or that do not vary (directly or indirectly) with underlying items are presented in accordance with the general requirements of the ED, ie:

      (i) as an offset to the contractual service margin, for changes in estimates of cash flows that relate to future service;

      (ii) in profit and loss, for changes in estimates of cash flows that do not relate to future service, and for the risk adjustment; and

      (iii) in OCI for the effect of changes in the discount rate.

7. Thus, the ED proposed different requirements for changes in the fulfilment cash flows that vary indirectly with underlying items (which are intended to include embedded options and guarantees), depending on whether the contract met the criteria for mirroring. This is as follows:

   (a) When mirroring applies, the changes in the fulfilment cash flows that vary indirectly with underlying items would be presented in profit or loss.

   (b) When mirroring does not apply, the changes in the fulfilment cash flows that vary indirectly with underlying items are recognised as described in paragraph 6(b).

Constituent views on the mirroring approach

8. Many respondents were sympathetic to the IASB's intention of eliminating accounting mismatches for some participating contracts. However, the proposals

in the ED were widely criticised for being unduly complex and many constituents questioned whether they could be made workable. Furthermore, many constituents disagreed that some types of participating insurance contract should be measured on a different basis from other insurance contracts.

9. Many constituents believe that it would be difficult for entities to separate and separately measure the different components of the insurance contract that would be accounted for differently. Some felt that any decomposition of inter-related cash flows is arbitrary and that this would lead to different valuations of an insurance contract depending on arbitrary decisions.

10. Many constituents were concerned because the mirroring proposals would mean that the measurement outcome for some participating contracts would differ from the measurement outcome for other insurance contracts.

11. Some constituents stated that they would prefer all insurance contracts to be measured in the same way, because otherwise there would be reduced comparability, for example:

    (a) between an insurance contract for which the entity accounts for the assets backing the contract at amortised cost and an otherwise identical contract for which the entity accounts for the assets backing the contract at fair value; and

    (b) between contracts to which mirroring applies and those to which it does not, as described in paragraph 7. Some believe that the marked difference in accounting does not reflect the more subtle differences in contract characteristics, and believe the proposals to portray a misleading difference.

12. In addition, some preparers and regulators were concerned that when the underlying items are measured at cost, the carrying value of the insurance contract would not be a current value. As a result, it would widen the difference between the liability measured for financial reporting purposes, and the liability recognised for regulatory purposes.

13. It was in the light of this feedback on the mirroring approach that the IASB has developed the variable fee approach. Under the variable fee approach an insurance contract with direct participation features is viewed as an obligation to

pay to policyholders 100% of the fair value of the underlying items less a variable fee for service.

14. The staff note that there was one exception to the general feedback on the mirroring approach. This is that a few constituents said that mirroring was necessary for mutual insurers because the effect of accounting mismatches between assets that cannot be measured at fair value and fulfilment cash flows measured at current value can have a significant effect on their reported financial position and performance.

Staff analysis

Why mutual entities support the mirroring approach

15. The ownership and capital structure of a mutual insurer has the consequence that accounting mismatches that may arise in the absence of a mirroring approach have a greater significance for mutual insurers than they would for insurers owned by a shareholder (a 'proprietary insurer').

16. A mutual insurer does not have shareholders. Instead it has one or more categories of policyholder which share to varying degrees in the gains and losses of the entity. This is because mutual insurers issue contracts which require the entity to make payments that provide its policyholders with a share in the returns on the entity itself. Therefore a defining feature of a mutual insurer is that the most residual interest of the entity is due to a policyholder and not a shareholder. A mutual insurer may conclude that its existing resources are more than sufficient to satisfy its obligations to current policyholders, and that any excess is a reserve created for the fulfilment of unforeseen events, or failing that, for the benefit of future policyholders. Under the IASB's proposed insurance contracts Standard, payments form part of fulfilment cash flows regardless of whether those payments are expected to be made to current or to future policyholders. Thus, the fulfilment cash flows of a mutual insurer generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for a mutual

insurer, there should normally be no equity remaining and no net comprehensive income reported in any accounting period[2].

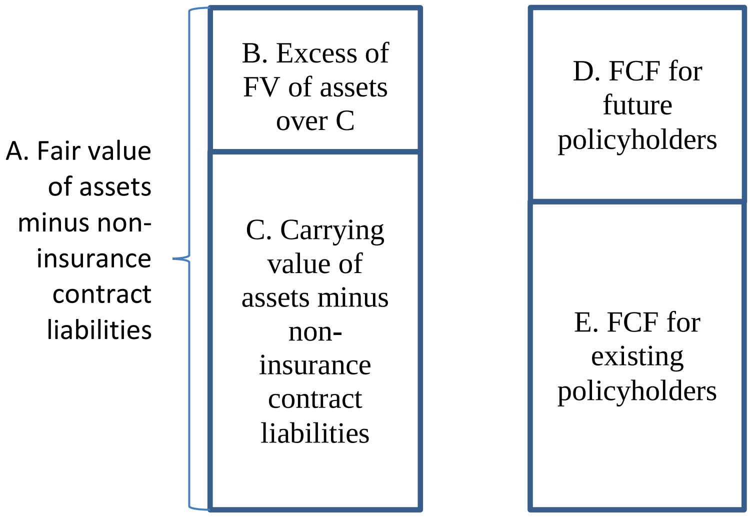
17. The staff note that several respondents to the ED questioned whether it is appropriate for mutual insurers to report no equity. Similar concerns about mutual insurers reporting no equity have been expressed in response to previous consultation documents, dating back to the Exposure Draft that preceded IFRS 4, in 2003.

18. There is an additional issue that arises because of potential accounting mismatches between the measurement of insurance contracts and the other net assets of a mutual insurer. Insurance contracts are measured at current value which, for a mutual insurer, incorporates information about the fair value of the other assets and liabilities of the entity. Many assets and liabilities are not required to be measured at fair value in accordance with IFRS, for example, amortised cost financial assets, and some assets and liabilities are not allowed to be measured at fair value under IFRS, for example, deferred tax balances, goodwill in subsidiaries and pension scheme surpluses and deficits. Furthermore, the carrying amounts of assets that are not measured at fair value are more likely to be carried at a value lower than fair value than above fair value because of requirements to recognise impairment.

19. When liabilities are measured under the IASB's insurance contracts model, there is the possibility that mutual insurers would report liabilities that are greater than recognised assets in their financial statements, even though those entities are solvent for regulatory purposes. (Most if not all regulatory regimes treat payments due to future policyholders as unallocated surplus and therefore capital).

20. The diagram below summarises the financial position of a hypothetical mutual insurer.

[2] (a) A mutual could be in an economic deficit; and (b) staff have been made aware that there may be circumstances in which the residual assets of a mutual may not be attributable to policyholders.



21. Mutual insurers could minimise the effect of accounting mismatches by measuring as many assets and liabilities at fair value as is permissible under IFRS. The staff expect that assets and liabilities that cannot be measured at fair value are unlikely to be a significant proportion of total assets or liabilities or even net assets. Nonetheless, reporting an excess of fulfilment cash flows over recognised assets may be a concern to many mutual insurers, because it would mean that they would report negative equity.

22. To avoid mutual insurers reporting negative equity, some constituents suggest that the mirroring approach should be retained to eliminate or reduce the effect of accounting mismatches - at least for mutual insurers.

23. If the mirroring approach is retained for mutual entities, then the entity would measure the liabilities equal to assets in the statement of financial position. In other words, this approach would mean that the entity would measure the fulfilment cash flows so that D+E = C in the diagram above, and report zero equity.

Should mirroring be retained to eliminate accounting mismatches?

24. The staff note that one consequence of retaining the mirroring approach for mutual insurers would be that an identical insurance contract would be measured on a different basis only because it was issued by a mutual insurer, rather than a

proprietary insurer. The IASB's general principle is that economically similar products should be accounted for in a similar way regardless of the legal form of the entity holding or issuing the product.

25. In addition, the staff note that applying the mirroring approach would mean that part of the fulfilment cash flows of a mutual insurer would not be measured at current value. This is one of the main objections to the mirroring approach in the responses to the 2013 ED.

26. The accounting mismatches described in paragraph 18 would affect proprietary insurers as well as mutual insurers. However, the effect on the equity of proprietary insurers can be mitigated by the absorption capacity of shareholder equity.

27. Finally, the staff note that the issue of zero equity (or negative equity) for mutual entities is part of a wider financial reporting issue that is beyond the scope of the insurance contracts project. For example, the staff notes that IAS 32 *Financial Instruments: Presentation* envisions a situation in which a mutual entity reports zero equity[3].

28. Accordingly, the staff recommend that the IASB does not permit or require the mirroring approach for all entities.

Presentation formats for mutual entities

29. The staff note that IAS 1 allows reporting entities to present additional line items (and disaggregation of required line items), headings and sub totals in the statement of financial position and the statement of comprehensive income when such presentation is relevant to an understanding of an entity's financial position. In particular, the staff believe it may be relevant for a mutual insurer to distinguish:

    (a) In the statement of financial position, the liability attributable to policyholders in their capacity as policyholders from the liability attributable to policyholders in their capacity as owners; and

[3] See IAS 32 IE7

(b) In the statement of comprehensive income, the comprehensive income attributable to policyholders in their capacity as policyholders before determination of the comprehensive income attributable to policyholders in their capacity as owners.

30. For example, the statement of financial position of a mutual insurer could be presented as follows:

Statement of financial position	XX00 CU	XX01 CU
Assets	100	108
Liabilities due to policyholders in their capacity as policyholders	45	51
Liabilities due to policyholders in their capacity as owners	60	64
Total liabilities	105	115
Net assets	(5)	(7)
Equity interest attributable to policyholders in their capacity as owners[4]	5	7
	0	0

31. The statement of comprehensive income could be adapted to show that comprehensive income is attributable to policyholders in their capacity as owners. For example:

[4] Equity interests arise because of differences between the fair value of underlying items and the amounts recognised in the statement of financial position

Statement of comprehensive income	Year 1 CU
Insurance contract revenue	8
Claims and benefits	(8)
Investment income and gains	8[5]
Increase in liability to policyholders in their capacity as policyholders	(6)[6]
	2
Increase in liability to policyholders in their capacity as owners	(4)[7]
Total comprehensive income attributable to policyholders in their capacity as owners	(2)

Staff recommendation

32. The staff recommend that the mirroring approach is not permitted or required in the proposed insurance contracts Standard. We note that a mutual insurer would be able to explain its capital position and the significance of recognising no equity, or negative equity, through presentation in its financial statements.

Question: Mirroring approach

Does the IASB agree that the mirroring approach proposed in the 2013 ED should not be permitted or required?

[5] CU108-CU100=CU8

[6] CU45-CU51=CU(6)

[7] CU60-CU64=CU(4)

Appendix A: Extracts from the 2013 Exposure Draft and Basis for Conclusions on the mirroring approach and mutual insurers

A1. 2013 ED

Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (paragraphs B83–B87)

33 An entity shall apply paragraph 34 if the contract:

(a) requires the entity to hold underlying items such as specified assets and liabilities, an underlying pool of insurance contracts, or if the underlying item specified in the contract is the assets and liabilities of the entity as a whole; and

(b) specifies a link between the payments to the policyholder and the returns on those underlying items.

The entity shall determine whether the contract specifies a link to returns on underlying items by considering all of the substantive terms of the contract, whether they arise from a contract, the law or regulation.

34 When paragraph 33 applies, the entity shall, at initial recognition and subsequently:

(a) measure the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items (meaning that paragraphs 18–27 do not apply); and

(b) measure the fulfilment cash flows that are not expected to vary directly with returns on underlying items in accordance with paragraphs 18–27. Such cash flows include fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated in accordance with paragraph 10.

66 If an entity applies paragraphs 33–34 because the insurance contract requires the entity to hold underlying items and specifies a link to returns on those underlying items, an entity shall recognise:

(a) changes in the fulfilment cash flows that result from applying paragraphs 33–34 in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of the underlying items;

(b) changes in the fulfilment cash flows that are expected to vary indirectly with those returns on underlying items in profit or loss; and

(c) changes in the fulfilment cash flows that are not expected to vary with those returns on underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), in profit or loss and in other comprehensive income in accordance with paragraphs 60–65.

67 An entity shall not offset income or expense from the underlying items against expense or income from the insurance contract.

A2. 2013 ED Application Guidance

B16 An entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder. In the case of a mutual entity, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual entity is a separate entity that has accepted the risk that is the essence of the insurance contracts.

A3. 2013 ED Basis for Conclusions

BCA62 Some insurance contracts that specify payments to policyholders based on underlying items are issued by mutual entities, while others are issued by investor-owned entities. The IASB has identified no reason to adopt different treatments for these contracts on the basis of the legal form of the issuer. This means that, if the contract provides policyholders with the right to participate in the whole of any surplus of the issuing entity, there would be no equity remaining and no profit reported in any accounting period. In the FASB's approach, a mutual entity treats as equity an amount of surplus that the entity does not have the obligation or intention to pay out in fulfilling the insurance contract obligations. The FASB believes that this approach is consistent with its treatment of the cash flows resulting from any other entity's discretionary participation features (that is, to include only cash outflows that an entity will incur to directly fulfil its obligation to the policyholders). In addition, the FASB believes that presenting the amounts the entity is obligated and intends to pay its policyholders as a liability, and this 'notional' surplus that it is not obligated and does not intend to pay to policyholders as equity, would provide more useful information to users of the financial statements of mutual entities and would be more comparable to other entities that issue similar insurance contracts.