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STAFF PAPER

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Introduction

1. This Agenda Paper provides an update on the IASB's project on the accounting for insurance contracts.

Overview of the project

2. When the IASB began its work in 2001, International Accounting Standards had no Standard on insurance contracts. In anticipation of adoption of IFRS by a number of jurisdictions, the IASB published IFRS 4 *Insurance Contracts* (IFRS 4). This Standard generally allowed entities to maintain their existing accounting practices, subject to improved disclosures about those practices and about risks related to insurance contracts. IFRS 4 was intended as an interim measure pending a more fundamental reassessment of the accounting for insurance contracts.

3. The objective of the IASB's insurance contracts project is to develop an accounting approach for insurance contracts that:

    (a) provides up-to-date, market-consistent information about the entity's obligations, including the value of options and guarantees;

    (b) requires entities to reflect the time value of money on payments expected in future;

(c) reflects the characteristics of the insurance contract rather than the assets that an entity holds, and therefore reflects the risks related to the investment activity;

(d) provides separate information about the investment and underwriting performance; and

(e) treats the compensation for service provided by the underwriting activity as revenue. Revenue and expenses are presented in the profit or loss in a comparable way to other, non-insurance business.

4. Since January 2014, the IASB has been deliberating issues raised in its third consultation document, which was a revised Exposure Draft published in June 2013. The 2013 Exposure Draft *Insurance Contracts* (2013 ED) builds on the proposals previously set out in:

(a) the Discussion Paper *Preliminary Views on Insurance Contracts*, published in May 2007, which explained the IASB's initial views on insurance contracts; and

(b) the Exposure Draft *Insurance Contracts*, published in July 2010, which developed those initial views into a draft Standard.

5. The IASB has followed a comprehensive due process and undertaken extensive consultation with interested parties, including:

(a) publishing three consultative documents (listed in paragraph 4) on which it received comment letters from constituents including preparers, regulators, auditors and standard-setters;

(b) meeting a broad range of stakeholders from all jurisdictions that have an interest in insurance operations (including users of financial statements, auditors, preparers, regulators); and

(c) testing the proposals in three rounds of fieldwork with preparers of financial statements.

6. In its deliberations, the IASB has sought to balance many diverse views and to develop an approach that provides useful financial information and that can be applied all around the world.

Contracts without participation features

7. The IASB has completed its discussions on the model for insurance contracts *without* participation features. This has included consideration of issues that were not targeted for input in the 2013 ED that the IASB nonetheless agreed to reconsider. Appendix A provides a high-level overview of the IASB's general model for insurance contracts.

Contracts with participation features

8. A participating feature is the mechanism by which the entity shares rewards and risks with the policyholder through additional payments, other than payments that are commensurate to the loss suffered on the occurrence of an insured event. The approach for the IASB's deliberations for contracts with participation features has been to consider what adaptations to the decisions for contracts *without* participation features would be needed to make them appropriate for contracts with participation features.

9. Under the IASB's decisions to date, contracts with participation features are accounted for under:
   - (a) the general model. The general model includes requirements that reflect the presence of participation features in insurance contracts, for example in the estimate of expected cash flows and in the discount rate used to discount those cash flows; and
   - (b) a modification of the general model so that changes in the estimate of the fee that the entity expects to earn from the contract are adjusted in the contractual service margin (termed the 'variable fee approach'), if the contract has a direct participation feature.

10. Contracts with direct participation features are contracts for which:
    - (a) the contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items;
    - (b) the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and

(c) a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

11. For such contracts, the IASB has decided that an entity should apply the variable fee approach[1], in which the entity's obligation to the policyholder is considered to be the net of:

(a) the obligation to pay the policyholder an amount equal to the fair value of the investment portfolio (referred to as 'underlying items'). The underlying items are referenced assets, or a pool of assets and liabilities, on which the obligation is based; and

(b) the variable fee that the entity deducts in exchange for the services provided by the insurance contract. The fee that the entity expects to earn from the contract is equal to the entity's expected share of the returns on underlying items, less any expected cash flows that do not vary directly with the underlying items (eg costs, minimum financial market guarantees).

12. Accordingly, changes in the estimate of the variable fee for future services would be accounted for in a way consistent with the changes in estimate relating to future service. Such changes in estimates would be adjusted in the contractual service margin so that they would be recognised in future periods, rather than in the period in which they occur.

Topics for consideration this month

13. This month, the IASB will be considering further issues relating to the accounting for contracts with participation features. These relate to:

(a) The presentation in the statement of comprehensive income of amounts in profit or loss and other comprehensive income; and

[1] Further details are in the IASB's March 2015 Agenda Paper 2B: *Insurance Contracts: Adaptations for insurance contracts that provide policyholders with investment returns: Proposed accounting for CSM and OCI* and June 2015 Agenda Paper 2B: *Insurance Contracts: Variable fee approach for direct participation contracts* available on the IASB's website at www.ifrs.org.

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(b) How to avoid accounting mismatches that might arise in some situations in which the variable fee approach is applied.

14. With respect to presentation, the IASB will be considering the objective for disaggregating amounts between profit or loss and other comprehensive income (OCI). The staff are recommending that the forthcoming Standard should:

    (a) specify that the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI is to present an insurance investment expense in profit or loss using a cost measurement basis. Accordingly, the difference between an insurance investment expense using a cost measurement basis and current measurement basis is recognised in OCI; and

    (b) not specify detailed mechanics for the determination of the insurance investment expense using a cost measurement basis.

15. The IASB will also be considering whether different requirements for disaggregating amounts between profit or loss and other comprehensive income are needed for some specific contracts in which there are no economic mismatches between the contract and the items held by the entity. Those requirements would result in an entity presenting an insurance investment expense that eliminates accounting mismatches in profit or loss with items held that are measured using a cost measurement in profit or loss. Those requirements are referred to as the ‘current period book yield approach’ and would apply to a specified subset of contracts with direct participation features.

16. With respect to avoiding accounting mismatch, the staff are recommending that when an entity mitigates financial market risk from the guarantee(s) embedded in contracts with direct participation features by using derivatives, an entity should be *permitted* to recognise in profit or loss the changes in the value of the guarantee embedded in an insurance contract in some circumstances.

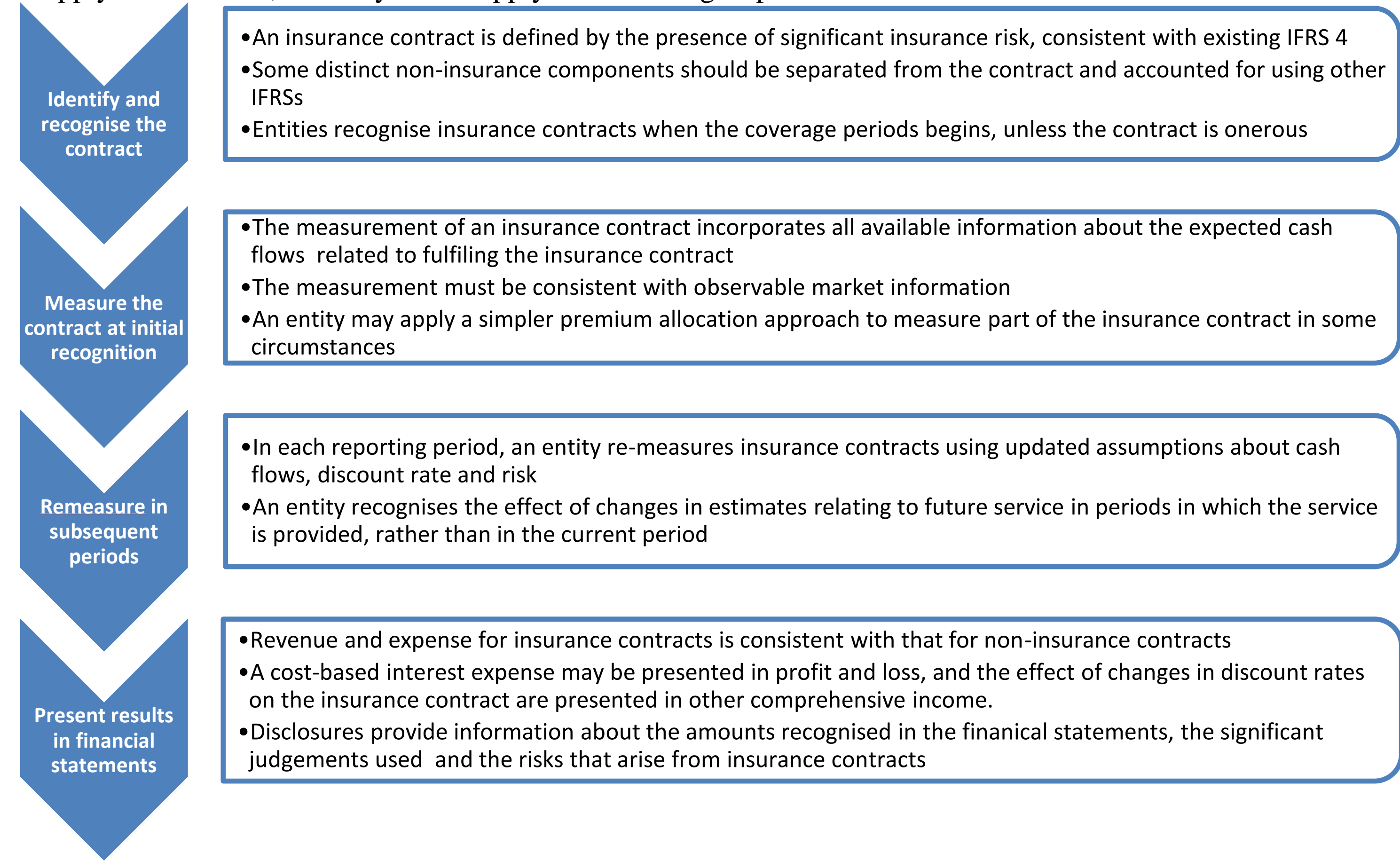
Next steps

17. The IASB has now substantially completed its deliberations on most of the proposals in the 2013 ED and is currently finalising its deliberations on the most difficult of the issues on which it originally sought input, ie those relating to the accounting for contracts with participating features. The IASB expects to complete its deliberations on insurance contracts in 2015, with a view to issuing the new Standard in 2016.

An accounting model for insurance contracts

The proposed Standard describes a measurement and presentation model for insurance contracts.

To apply the Standard, an entity would apply the following steps:



Current, market-consistent information on the balance sheet

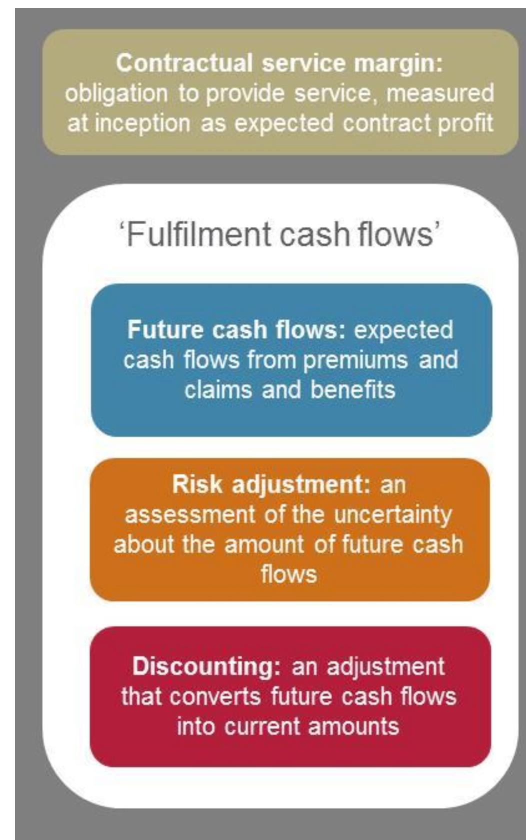
There is widespread support for the IASB's proposal that there should be a current market-consistent approach to measuring insurance contracts.

The proposed approach provides a current assessment of the net financial position at the end of each reporting period. The financial position reflects:

- the net obligation to provide coverage (and other services) and to pay claims in future periods; or
- the net right to the payment for the services provided in previous periods.

A current market-consistent approach ensures that the economic cost of the insurance contract, including embedded options and guarantees will be transparent.

The insurance contract asset or liability is measured incorporating the following components:



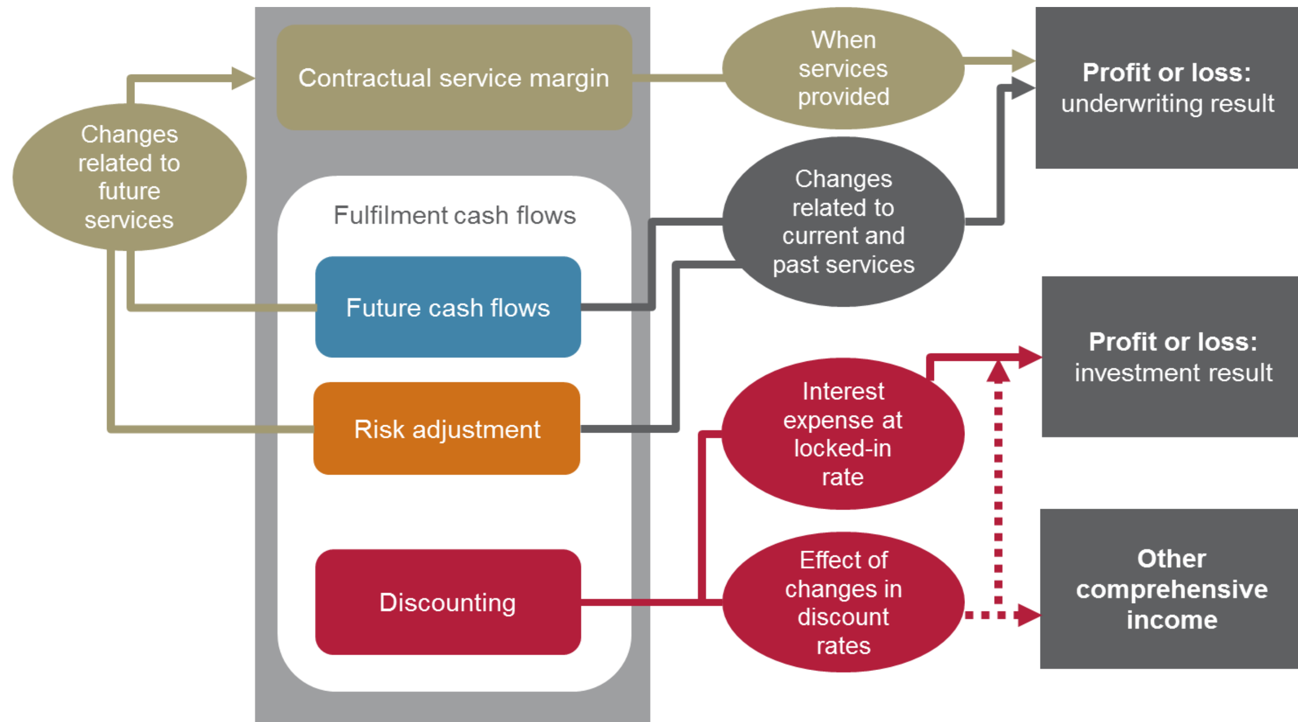
Reflecting changes in the balance sheet amounts

Many constituents raised concerns about reporting all changes in the measurement of insurance contracts immediately in profit or loss.

Many strongly believed that it would cause 'unwarranted volatility' and would not appropriately reflect the nature and timing of the services provided.

In response, the IASB proposed to disaggregate changes in the measurement of the insurance contracts in different line items on the face of the financial statements, depending on the sources of the changes.

The changes in the measurement of the insurance contract are illustrated in the following diagram.



Thus, changes in the measurement of the liability relating to the underwriting services should:

- be recognised in profit or loss in the current period, if related to service provided in the current and past periods; and
- adjust the contractual service margin so that they are recognised in profit or loss in future periods, if related to service to be provided in future periods.

In addition, changes in investing activity may be disaggregated into a cost-based interest expense in profit or loss, and the effect of changes in discount rate in OCI.

The statement of total comprehensive income explains sources of profit and improves comparability with other transactions

The existing accounting for insurance contracts often fails to explain clearly the sources of the entity's profit. In addition, it does not provide information that is comparable to other, non-insurance business.

IASB proposals make insurance accounting less 'special'. Although, some aspects of insurance contracts are sufficiently different to justify a different accounting, basic issues related to the measurement of insurance contracts and presentation of its performance are similar to other industries.

The format of the statement of comprehensive income is illustrated below.

Statement of Comprehensive Income

	20XX
Insurance contracts revenue	X
Incurred claims and expenses	(X)
Underwriting result	**X**
Investment income*	X
Interest on insurance liability	(X)
Investment result	**X**
Profit or loss	**X**
Gains and losses on financial assets measured at fair value through OCI*	
Effect of discount rate changes on insurance liability (optional)	(X)
Total comprehensive income	**XX**

*Amounts recognised, measured and presented in accordance with IFRS 9 *Financial Instruments*

Revenue and expenses excludes deposits and recognised as earned or incurred

Interest expense is either current or 'locked-in', depending on accounting policy choice

If interest expense is 'locked-in', effect of difference between current and locked-in rates is presented in OCI

The statement of comprehensive income proposed by the IASB presents:

- gains or losses on underwriting activity separately from gains or losses from investing premiums received from customers.
- revenue and expenses from insurance contracts consistently with the presentation of revenue and expenses in accordance with IFRSs for other transactions.

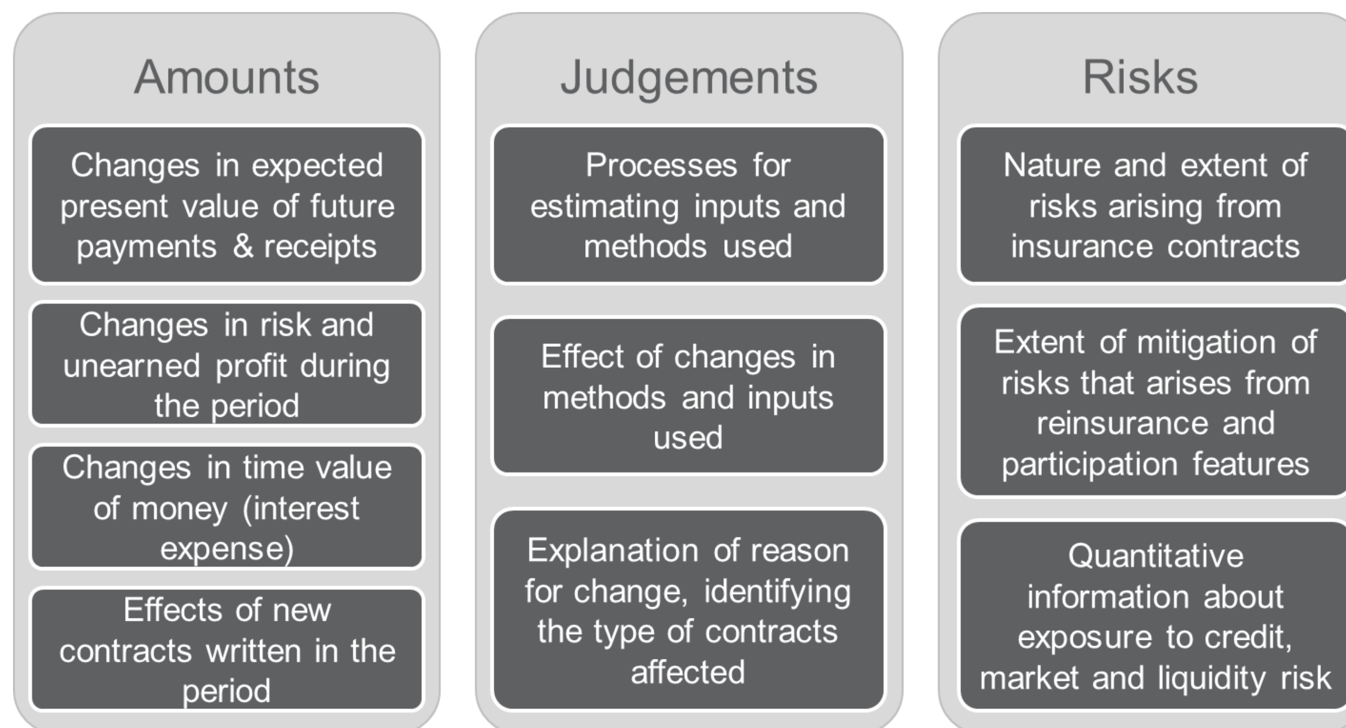
Disclosures explain the amounts recognised in the financial statements and the risks arising from the insurance activity

The complexity of insurance contracts, their inherent risk and the need to base measurement on assumptions necessitates comprehensive disclosures to provide transparency.

The IASB proposes to extend the existing disclosures in IFRS 4 relating to the risks and amounts reported in the financial statements. In addition, the IASB proposes:

- more detailed reconciliations of the amounts recognised in balance sheet and profit or loss; and
- more information about judgements used in measuring insurance contracts.

The disclosures will provide the following types of information:



A simplified measurement approach for simpler contracts

The proposed standard includes a simplified measurement approach that approximates the general proposals. That approach is expected to significantly reduce the costs of application of the new Standard for many entities.

The simplified approach is similar to the unearned premium reserve approach used in many jurisdictions today.

When could the simplified approach be used?

An entity could use the simplified approach when the outcome approximates that from applying the general measurement model ie when significant changes in estimates are not expected in the period before the claims are incurred, or when the coverage period of the contract is less than a year.

What is the simplified approach?

An insurance contract liability can be analysed as comprising of:

- the insurer's obligations to pay for the future insured events covered by the existing contracts (the liability for remaining coverage); and
- the insurer's obligation to pay claims for the insured events that have already occurred (the liability for incurred claims).

The premium allocation approach provides a simplified way of measuring the liability for remaining coverage. When applying that approach, an insurer would:

- on initial recognition, measure the liability for the remaining coverage at the premiums received under the contract, less any acquisition costs paid;
- subsequently, reduce the liability for the remaining coverage over the coverage period on the basis of the passage of time (or the basis of the expected timing of incurred claims and benefits, if that pattern better reflects the release from risk); and
- recognise an additional liability if a contract is onerous. That liability calibrates the carrying amount of the liability for remaining coverage to the amount of fulfilment cash flows.

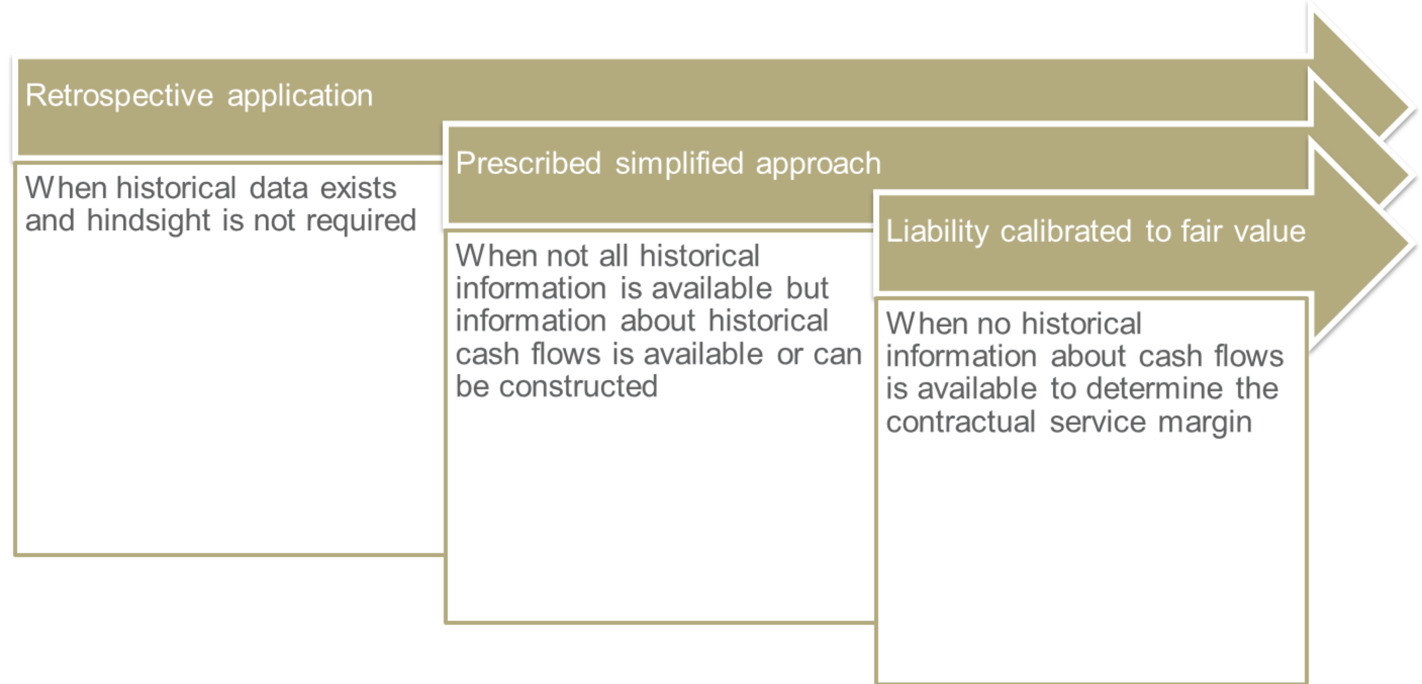
The liability for incurred claims is measured using the general model.

Applying the new Standard for the first time (transition)

The proposals related to the application of the new Standard for the first time seek to balance:

- the desire for comparability (i) between different entities applying the new Standard for the first time and (ii) between contracts written by an entity before and after the first application of the new Standard; and
- the feedback from constituents that any retrospective approach may be difficult to apply because it requires use of historical information.

An entity applying the new Standard for the first time would use one of the following approaches:



The IASB proposes that an entity should apply new accounting policies that result from the new Standard as if those policies had always been applied, where practicable. This approach provides most comparability. When this is not practicable, the IASB specifies two approaches to overcome difficulties in obtaining historical information for long-duration contracts.