STAFF PAPER

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IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Level of aggregation for the measurement of the contractual service margin		

CONTACT(S)	Izabela Ruta	iruta@ifrs.org	+44 (0)20 7246 6957
	Anne McGeachin	amcgeachin@ifrs.org	+44 (0)20 7246 6486

Purpose of this paper

1. This paper considers the objective for the level of aggregation to be applied in measuring the contractual service margin after initial recognition, and the guidance that should be provided on how an entity can meet that objective.

2. Although the staff previously considered the level of aggregation separately for the adjustments to the contractual service margin arising from changes in estimates and for the allocation of the contractual service margin to profit or loss, this paper considers those effects together, because of their interaction.

Staff recommendation

3. The staff recommends that the Board:

   (a) Specify that the objective for the adjustment and release of the contractual service margin is that the contractual service margin at the end of the reporting period represents the profit for the future services to be provided for a group of contracts.

(b) Specify that the group of contracts used for measuring the contractual service margin should be the same as the group used for determining when contracts are onerous. Consequently, an entity should measure the contractual service margin by grouping insurance contracts that at inception have:

(i) expected cash flows that the entity expects will respond in similar ways to changes in key assumptions in terms of amount and timing; and

(ii) similar expected profitability, ie contractual service margin as a percentage of the total expected revenue. An entity can use as a practical expedient an assessment of the expected return on premiums, ie contractual service margin as a percentage of expected premiums.

(c) Require that when allocating the contractual service margin of the group of contracts to profit or loss an entity should reflect the expected duration and size of the contracts remaining at the end of the period in the group.

Layout of the paper

4. Paragraphs 6-7 give background information.

5. Paragraphs 8-24 give the staff analysis:

(a) An example illustrating the differences between measuring contracts on a group basis and on an individual basis.

(b) The need for a group for the subsequent measurement of the contractual service margin.

(c) Other issues: the possibility of adding contracts to the group in later periods.

Background

6. In January 2016 the Board tentatively decided that the onerous contract test (both at initial recognition and on subsequent measurement) should be performed on a group level, rather than based on an individual contract. The Board recognised that the accounting outcome of identifying onerous contracts at a group level could differ from the outcome at an individual contract level and clarified that an entity should not recognise losses for individual contracts if the group to which they belong is not onerous. That group was defined as contracts that at inception:

   a. *have cash flows that the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing[1]; and*

   b. *had similar expected profitability (ie similar contractual service margin as a percentage of the premium).*

7. At that meeting, the Board also:

   (a) tentatively confirmed its decision from June 2014 that the objective for the allocation of the contractual service margin to profit or loss is to recognise profit in relation to each individual contract and that an entity could aggregate the contracts as long as the outcome of the allocation of the group meets this objective.

   (b) noted that the group of contracts identified for the onerous test is deemed to meet that objective provided that an entity adjusts the allocation of the contractual service margin for the group in the period to reflect the expected duration and size of the contracts remaining at the end of the period.

[1] During drafting, the staff have refined the wording to refer to changes in key assumptions rather than key drivers of risk.

Staff analysis

An example

Example 1: Differences between measuring contracts on a group basis and on an individual contract basi.s

8. Assumptions:

   (a) There are 3 homogenous contracts that cover the same risk (for example the risk of a car crash), with a coverage period of 3 years;

   (b) Each contract is expected to have a claim of CU 3.5 every year until the contract lapses;

   (c) Each policyholder pays a premium of CU10 at inception;

   (d) The entity expects that one contract will lapse after each year. Thus in year 1, the entity provides service for all 3 contracts. In year 2, the entity provides service for 2 contracts, and in year 3 the entity provides service for only 1 contract.

   (e) For simplicity, the time value of money and the risk adjustment are negligible.

9. The expected cash flows for each contract are presented in Table 1 below.

Contract expected to last:	1 year	2 years	3 years	Total	Average
Premiums	10.0	10.0	10.0	30.0	10.0
-Claims	3.5	3.5*2=7.0	3.5*3=10.5	21.0	7.0
= Profit	6.5	3.0	-0.5	9.0	3.0

10. At inception, an entity does not know which contract will lapse and when. Consequently, each contract has an expected length of 2 years, expected cash outflows of CU7 and contractual service margin of CU3. However, only one of the three contracts will have actual cash flows that equal the average cash flows, even when everything occurs as expected.

Individual contract basis

11. After Year 1, the entity knows which contract has lapsed. If the entity were to account for each individual contract on a separate basis, when the contract has lapsed:

(a) there is a change in expectations for all contracts.

(i) For the contract that lapsed there was a change because this contract was expected to be in force for 2 years but lapsed after 1 year (and therefore incurred claims for 1 year instead of 2 years). Consequently, the entity will decrease the expected cash outflows for this contract by CU3.5 (from CU7.0 to CU3.5) and therefore the contractual service margin will increase from CU3 to CU6.5.

(ii) In contrast, for the remaining 2 contracts that did not lapse, the entity will increase the expected cash outflows by CU3.5[2] and decrease the contractual service margin for the same amount. The revised contractual service margin for the two contracts together equals CU2.5 (CU6-CU3.5).

(b) the entity would recognise in profit or loss the contractual service margin for each contract in proportion to the expected length of the contract. In accordance with this method, the entity would recognise in total CU7.5 of contractual service margin calculated as follows:

(i) the whole contractual service margin for the contract that has finished ie CU6.5; and

(ii) The portion of contractual service margin for contracts that remained in force ie CU1 (CU2.5*1year/ 2.5 years).

12. Table 2 below summaries the contractual service margin at the end of each period and the change in the contractual service in each period calculated on an individual contract basis.

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[2] The average expected future cash outflows for those contracts increased from CU7 (CU3.5* 2contracts* 1years) to CU10.5 (CU3.5*(1years+2years)).

	Year 1	Year 2	Year 3
Opening balance	9.0	1.5	-0.5
Change in estimates, consist of: a. contract that lapsed b contracts in force	- +3.5 -3.5	- +1.75 -1.75	- - -
Allocation, consist of: a. contract lapsed b. contracts in force	-7.5 -6.5 -1.0	- 2.0 -2.5 +0.5	-0.5 -0.5 -
Closing balance	1.5	-0.5	-

Group basis

13. In contrast, if the entity were to account for contracts on a group basis, when contract 1 has lapsed:

    (a) The group behaved as expected and there is no change in expectations.

    (b) The entity will recognise in profit or loss the total contractual service margin in proportion to the expected length of the contracts within the group. The staff have assumed that the entity would allocate the contractual service margin in proportion to the coverage years provided for the period. Accordingly, the entity will recognise CU4.5 of contractual service margin for Year 1 calculated as follows:

        (i) The proportion of the service provided for the period equals 50% of the expected service to be provided for the whole group (3 contracts for a period / 6 total contract years[3]).

        (ii) The contractual service margin recognised in profit or loss for the period equals CU4.5 (total contractual service margin of CU9 *50%).

[3] Total contract years of 6 = sum of the expected length of each contract ie 1 contract for a year + 1 contract for 2 years + 1 contract for 3 years.

14. Table 3 below summaries the contractual service margin at the end of each period and the change in the contractual service in each period calculated on a group basis.

	Year 1	Year 2	Year 3
Opening balance	9.0	4.5	1.5
Change in estimates	-	-	-
Allocation, consist of: a. contract lapsed b. contracts in force	-4.5 -1.5 -3.0	-3 -1.5 -1.5	-1.5 -1.5 -
Closing balance	4.5	1.5	-

The need for a group for the subsequent measurement of the contractual service margin

15. Example 1 illustrates that different outcomes would occur if contracts were measured on a group basis relative to the outcome that would occur if contracts were measured on an individual basis, even when the actual cash flows equal the expected cash flows at a group level.

16. However, the staff did not intend the June 2014 decision (to set the objective as the measurement of individual contracts) to give rise to a different accounting result when the group of contracts behaves as expected. The staff now think that because of the different results that arise under an individual contract basis than arise under a group basis, we need to specify that the measurement should be done on a group basis.

17. That outcome would be consistent with the Board's view, reflected in the tentative decisions relating to the group level of aggregation for onerous contracts, that users of financial statements are unlikely to find information about losses relevant when expectations of claims across a group of similar contracts as a whole have not changed, but it is now clearer which contracts in that group will result in

claims. This is because the same change in expectations that could cause some contracts to be loss-making would also make some contracts less profitable.

18. In applying a group basis, the staff think it is important that the allocation of the contractual service margin reflects the expected duration and size of the contracts in the group. This is to prevent an allocation that:

    (a) recognises the contractual service margin equally in profit or loss in each period when the number of contracts differs in each period. For example, in Example 1, an entity should not recognise CU3 each reporting period but rather CU4.5 in year 1, CU3 in year 2 and CU1.5 in year 3; and

    (b) does not recognise a higher contractual service margin in the period when a large contract lapses.

19. From a practical perspective, applying the same group to the measurement of the contractual service margin as for determining onerous contracts would simplify the proposals for the measurement of the contractual service margin and could avoid the need to have a separate component of the insurance contract liability for onerous groups.

20. Consequently, the staff recommend that for the measurement of the contractual service margin after initial recognition, the Board removes the objective of using the individual contract and extends the application of the group of insurance contracts defined in January 2016 for the purpose of the onerous test.

21. As a drafting issue, the staff note that the description of profitability used in January 2016 tentative decision as being the ratio of the contractual service margin to premiums is not correct. This is because the premiums may include an investment component. Consequently, the staff recommend that the wording of that condition should be changed to state that an entity should include contracts within the group:

    (a) with similar profitability (ie the ratio of contractual service margin to expected total revenue); and

    (b) as a practical expedient, give an alternative assessment of similar expected returns on premiums (ie the ratio of contractual service margin to expected premiums). This is because it will be difficult for many entities to exclude the total expected investment component from the premiums.

Question 1: Subsequent measurement of the contractual service margin
Does the Board agree to: a. Specify the objective for the contractual service margin is to represent the profit for the future services to be provided for a group of contracts? b. Specify that the group used for measuring the contractual service margin should be the same as the group used for determining when contracts are onerous. Consequently, an entity should measure insurance contracts by grouping insurance contracts that at inception have: i. expected cash flows that the entity expects will respond in similar ways to changes in key assumptions in terms of amount and timing; and ii. similar expected profitability (ie contractual service margin as a percentage of the total expected revenue). An entity can use as a practical expedient the expected return on premiums (ie contractual service margin as a percentage of expected premiums)? c. Require that when allocating the contractual service margin of the group of contracts to profit or loss an entity should reflect the expected duration and size of the contracts remaining at the end of the period in that group?

Other issues: the possibility of adding contracts to the group in later periods

22. When discussing the level of aggregation, a recurring question is whether an entity can add new contracts to the group at some point after the group's inception. The staff believe that an entity should be able to add contracts that at their inception are similar to the characteristics of the group at the date the contract joins the group. Adding such contracts would not change significantly the profile of the group at that date.

23. The new contract will be similar to the characteristics of group if it meets the conditions in the definition of the group, assessed at the date of joining the group. Hence the contract must have cash flows that the entity expects will respond in similar ways to changes in key assumptions in terms of amount and timing and have similar profitability. This condition must be met by comparing the initial expected cash flows and profitability of the contract joining the group with the current expected cash flows and the profitability of the group at the date the new contract joins the group. In other words the new contract must be similar to the group as it currently is, not as the group was when it started.

24. The staff note that new contracts will often not meet the criteria for joining the group even if those contracts have similar terms comparing to the contracts that formed the group at inception. This is because even if the profitability of the new contracts is the same as the group, changes in the key assumptions are unlikely to affect the expected cash flows of the new contracts in the same way as they affect the remaining expected cash flows of the group.