IFRS

STAFF PAPER

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ASAF Meeting

Project	Insurance Contracts		
Paper topic	IASB staff response to the AASB & NZASB staff paper on Contractual Service Margin recognition – non-participating contracts		
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Purpose of the paper

1. At its meeting in May 2014, the IASB reaffirmed that the contractual service margin (CSM) of an insurance contract without participation features should be recognised in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of the services provided by the contract. The IASB proposed that the transfer of services should be considered to occur on the basis of the passage of time and reflect the number of contracts in force.

2. In Agenda Paper 1C *Contractual Service Margin (CSM) recognition – non-participating insurance contracts*, the staff of the Australian Accounting Standards Board (AASB) and New Zealand Accounting Standards Board (NZASB) propose that the transfer of services should be considered to occur:

    (a) on the basis of the passage of time; and

    (b) except if the expected pattern of release of risk differs significantly from the passage of time, when it should be on the basis of expected timing of incurred claims and benefits.

3. In this paper the IASB staff respond to the main arguments in Agenda Paper 1C and explain the IASB's rationale for its proposal. This paper has not been reviewed by the IASB and does not represent the views of the IASB.

Background information

General model

4. The IASB is in the final stages of developing a model for the accounting for insurance contracts. That model proposes that an entity should measure an insurance contract at initial recognition as the sum of:
   (a) the fulfilment cash flows, which is the present value of all expected cash inflows and outflows, including a risk adjustment; and
   (b) the CSM calculated as the difference between the present value of expected cash inflows and cash outflows adjusted for risk[1].

5. The risk adjustment and CSM are subsequently recognised in profit or loss; as follows:
   (a) The risk adjustment is recognised in profit or loss as the entity is released from risk, consistent with the definition of the risk adjustment as the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract.
   (b) The CSM is recognised in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services provided by the insurance contract.

6. Feedback on the 2013 ED indicated that constituents expected that there would be significant subjectivity and consequential inconsistencies in how the pattern of

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

services provided was interpreted. The CSM allocated to the profit or loss will be a significant indicator of the performance of the insurance business.

7. Accordingly, at its meeting in May 2014, the IASB tentatively decided to clarify that, for contracts without participation features, the service represented by the CSM is insurance coverage which:

    (a) is provided on the basis of the passage of time; and

    (b) reflects the expected number of contracts in force.

8. This decision reflects the IASB's conclusions that:

    (a) for non-participating contracts, the transfer of services should be considered to occur on the basis of the provision of insurance coverage. Insurance coverage is the service of standing ready to pay claims when an insured event occurs. Consequently, the IASB views the transfer of insurance coverage service as transferring to the policyholder on the basis of the passage of time.

    (b) the allocation of the contractual service margin should result in the contractual service margin for an insurance contract being fully recognised in profit or loss by the end of the coverage period of that contract. Thus, for a portfolio of contracts, an entity would expect to transfer more insurance coverage service (and hence to recognise a greater proportion of the contractual service margin in profit or loss) in the early years of the coverage period for a group of contracts, if it expects a significant proportion of insurance contracts to terminate before the end of their term, whether due to death, claims or lapses. Consequently, the IASB requiring that the allocation of the CSM should reflect the expected number of contracts in force.

Premium-allocation approach

9. The fulfilment cash flows of an insurance contract can be regarded as comprising two elements:

(a) a liability for the remaining coverage, which measures the entity's obligation to provide coverage to the policyholder during the remaining coverage period; and

(b) a liability for incurred claims, which measures the entity's obligation to investigate and pay claims for insured events that have already occurred, including incurred claims for events that have occurred but for which claims have not been reported.

10. The IASB proposals would permit an entity to simplify the measurement of the liability for the remaining coverage using the premium-allocation approach (PAA) if:

(a) doing so would produce a measurement that is a reasonable approximation to those that would be produced when applying the general approach; or

(b) the coverage period of the insurance contract at initial recognition (including coverage arising from all premiums within the contract boundary determined) is one year or less.

11. Under the PAA, the liability for the remaining coverage at initial recognition is measured as the sum of premiums received at initial recognition less any payments that relate to acquisition costs and certain other adjustments[2]. Subsequently, the carrying amount of the liability for remaining coverage is the previous carrying amount plus premiums received in the period minus an amount recognised as insurance contract revenue plus or minus other adjustments, eg, to reflect the time value of money.

12. In the PAA the three components of revenue in the general approach (ie release of the risk adjustment, allocation of the CSM and an amount equal to expected claims and benefits in a period) are combined in a single revenue measure which is allocated over the coverage period in the systematic way that best reflects the transfer of services. In other words, the PAA assumes that those three components should be recognised in profit or loss linearly and in the same proportion over the coverage period. The IASB concluded that this assumption would result in a similar outcome to the general model

[2] Other adjustments relate to pre-coverage cash flows and adjustment for onerous contracts.

(ie that the PAA would be a simplification of the general model) only in the restricted circumstances described in paragraph 10.

13. For the PAA, the IASB clarified that the transfer of services occurs:

(a) on the basis of the passage of time. This is consistent with the recognition of the CSM under the general approach; but

(b) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of the expected timing of incurred claims and benefits. This exception allows for a rebuttal of the presumption that that the release of risk is linear over the expected coverage period. To be consistent with the release of the risk adjustment recognised in profit or loss under the general approach (discussed in paragraph 5(a)), the recognition of revenue should reflect that non-linearity of the release of risk. Thus, when the entity expects the release of risk to be non-linear, the proxy of the release of the risk adjustment is the expected pattern of incurred claims and benefits.

14. The IASB staff observes that, consistent with the general model, the allocation of revenue in the PAA should result in the revenue from the contract being fully recognised in profit or loss by the end of the coverage period of that contract. Accordingly, as for the general model, the allocation of revenue in the PAA should also reflect the expected number of contracts in force.

IASB staff response

15. The table below sets out the IASB staff response to the key arguments in Agenda Paper 1C. This table is not intended to provide a response to every argument that is set out in Agenda Paper 1C.

	Issue	Ref[3]	Argument in the AASB/NZASB paper	IASB staff response
1	The number of contracts will not represent the amount of service provided	4(a) 23(a)	In many cases, the 'number of contracts' will not be representative of the services to be provided because, for example, larger contracts can be the last to settle or lapse (unless the level of portfolio aggregation were required to be based on having contracts of identical size, which would impose considerable operational complexity).	As described in paragraph 9, the requirement that the allocation of the contractual service margin should reflect the number of contracts in force is intended to achieve the IASB's principle that the CSM should be fully recognised in profit or loss by the end of the coverage period of that contract. Consequently, for a contract with a larger CSM which was the last to settle/lapse, the CSM of that contract should be released over its coverage period. The staff will consider in drafting how to ensure this point is clarified.
2	The CSM may reflect the cost of capital. The release of capital is not necessarily reflected by	4(b) 23(b)	The passage of time is not reflective of services provided to policyholders under some contracts, particularly when the CSM is largely associated with the cost of capital needed to back the contracts in order to provide the service to policyholders and this is far in excess of the capital the entity would choose to retain as a business decision. The AASB/NZASB	The IASB staff does not think that the requirement to hold capital transfers a service to the policyholders. Instead the requirement to hold capital is an activity that an entity must undertake to offer insurance products. The IASB staff expects that the capital an entity is required to hold by its prudential regulator would reflect the amount of risk created by the insurance contract. The risk

[3] Those numbers relate to the relevant paragraphs in the agenda paper 1C for this meeting prepared by the AASB & NZASB staff.

	Issue	Ref[3]	Argument in the AASB/NZASB paper	IASB staff response
	the passage of time		illustrate this point with the example of lenders' mortgage insurance.	adjustment is the compensation an entity requires for bearing risk (see paragraph5(a)). Accordingly, the IASB staff would expect that the compensation the entity requires for holding the capital would be reflected in the risk adjustment. In other words, the risk adjustment reflects the fact that the entity has charged a higher premium to achieve a return on regulatory capital.
3	Consistency between general approach and the premium allocation approach	4(c) 23(c)	Having different CSM recognition criteria for the general approach and the PAA undermines the notion that the two approaches are parts of the one measurement model.	IASB staff disagrees that there are different recognition criteria between the PAA and general approach. As discussed in in paragraph 13, the recognition pattern for the PAA is a combination of the recognition of the risk adjustment and CSM in the general model. The IASB believes that the recognition of the CSM under the general approach and the recognition of revenue under the PAA should result in the same profit outcomes between the general approach and the PAA, when the simplifications provided under the PAA are a good proxy of the risk adjustment in the liability for remaining coverage. As discussed in paragraphs 12-13, the rebuttable presumption is that the release of risk is linear over the expected coverage period. When this is not the case, the pattern of expected claims and benefits is a proxy under the PAA for release of the risk adjustment under the general approach under two simplifying assumptions: (1) the predominant driver of revenue in contracts qualifying for the PAA is risk; and (2) risk is generally released in these contracts when claims

	Issue	Ref[3]	Argument in the AASB/NZASB paper	IASB staff response
				or benefits are incurred. The IASB staff note that if the use of the PAA does not result in a reasonable approximation of the general approach, an entity would be prohibited from applying the PAA. (A practical expedient is provided that for contracts with a coverage period of one year or less, the PAA is a assumed to be reasonable approximation of the general approach).
4	Inconsistent with other IFRS / failure to reflect economic substance	4(d) 23(d)	It is inconsistent with the approach taken in other IFRS, which require a pattern to be applied for recognition purposes where such a pattern reflects economic substance	The IASB views the economic substance of providing insurance coverage is the service of standing-ready, which takes place over time (as discussed in paragraph 3). It is not settling the liabilities that arise from standing ready.
5	Standards should espouse principles rather than methods	23(e)	The passage of time combined with the number of contracts remaining in force is more of a 'method' than a 'principle' and, although in the vast majority of cases we would expect the unit of account to be portfolios of contracts, as a method it is not functional for a single contract because a single contract either persists or lapses	The IASB's view is that the principles are (1) the CSM is recognised in profit or loss according to the provision of service; and (2) the CSM for each contract should be fully recognised in profit or loss when the coverage period ends. The IASB staff note that the feedback on the 2013 ED indicated that the principles for recognising the CSM in profit or loss could be applied inconsistently. Given the significance of the recognition of the CSM the IASB thinks the subjectivity in determining the pattern of underlying services will create significant diversity in the pattern of

Issue	Ref[3]	Argument in the AASB/NZASB paper	IASB staff response
			recognition of the CSM in profit or loss is inappropriate.

Ref[4]	AASB & NZASB staff recommendation	IASB staff response
34	The AASB and NZASB staff recommend that, consistent with the IASB's tentative decision on the PAA, the CSM under the general approach be recognised in profit or loss: (a) on the basis of the passage of time; but (b) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits.	The IASB staff does not think that further amendments are necessary to increase consistency between the PAA and general model. This is because the IASB's tentative decisions will result in a consistent outcome in profit or loss (discussed in paragraph 13 and Row 3 in the table above). The AASB and NZASB staff recommendation implicitly assumes that under the general model the expected release of risk can only be on the basis of the passage of time or on the expected timing of incurred claims and benefits. The IASB staff disagrees with this and thinks that there could be other patterns for the release of risk under the general approach. Nonetheless, the IASB staff view is that the transfer of services to the policyholder reflected in the CSM is not the bearing of risk. The amount of risk related to each period is reflected in the risk adjustment and is recognised in profit or loss as the entity is released from risk. Neither does the IASB staff consider that the transfer of services is reflected by the pattern of incurred claims and

[4] Those numbers relate to the relevant paragraphs in the Agenda Paper 1C for this meeting prepared by the AASB & NZASB staff.

Ref[4]	AASB & NZASB staff recommendation	IASB staff response
		benefits. The expected claims are reflected in the cash flows that form part of insurance contract liabilities and are therefore, already considered in determining the carrying balance of the contractual service margin. The IASB staff thinks that the services represented in the CSM is insurance coverage, which is standing ready. The IASB staff thinks the service of standing ready is provided over the passage of time.

Question for ASAF members
Do you have any comments on the IASB staff analysis of the main arguments in Agenda Paper 1C?