

STAFF PAPER

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REG IASB Meeting

Project	Insurance contracts		
Paper topic	Cover note		
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Purpose of paper

1. This paper:
 - (a) Provides a reminder of the background for the IASB's project on insurance contracts (paragraphs 3-8);
 - (b) Provides an overview of the accounting model proposed by the IASB's 2013 Exposure Draft *Insurance Contracts* ('the 2013 ED') (paragraphs 9-14);
 - (c) Provides an overview of the papers for the April meeting, together with a summary of the staff recommendations (paragraph 16-28); and
 - (d) Summarizes project progress and next steps (paragraphs 26-27);
2. The appendices provide:
 - (a) In Appendix A: a summary of changes from the 2013 ED; and
 - (b) In Appendix B: a summary of tentative decisions to date and an indication of follow up needed on those decisions.

Background for the IASB's project on insurance contracts

Objectives

3. At present, IFRS has no comprehensive standard that deals with the accounting for insurance contracts. IFRS 4, published in 2004, is an interim Standard that provides disclosures, but permits a wide range of practices and includes a 'temporary exemption', which explicitly states that an entity does not need to ensure that its accounting policies are relevant to the economic decision-making needs of users of financial statements, or that those accounting policies are reliable. This means that:
 - (a) entities account for insurance contracts using different accounting models that evolved in each jurisdiction according to the products and regulations prevalent in that jurisdiction; and
 - (b) users of financial statements are not provided with all the information they need to understand the financial statements of entities that issue insurance contracts, or to make meaningful comparisons between entities.
4. The IASB's proposals are intended to improve financial reporting by providing more transparent, comparable information about:
 - (a) the effect of the insurance contracts an entity issues on the entity's financial performance;
 - (b) the way an entity makes profits or loss through underwriting risks and investing premiums from customers; and
 - (c) the nature and extent of risks that an entity is exposed to as a result of issuing insurance contracts.

Building on previous consultation

5. The 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* (the ‘2010 ED’), published in July 2010, which developed those initial views into a draft Standard.
6. The feedback received on the IASB’s earlier documents confirmed that there was widespread acceptance of the proposed approach to measure insurance contracts using a current, market-consistent approach (see paragraphs 20-28). That feedback indicated that many agree that such an approach would provide financial information that is relevant to users of the financial statements of entities that issue insurance contracts, and would faithfully represent the financial position and performance of such entities. As a result of this previous work, the IASB was satisfied that its measurement model for insurance contracts is appropriate and would result in improvements to financial reporting.
7. However, in response to issues identified in the comment letters, the IASB made some significant changes to the proposals in the 2010 ED. The IASB believes that those changes would increase the faithfulness of representation of insurance contracts in financial statements, and lead to entities providing more relevant and timely information about insurance contracts compared to the proposals in the 2010 ED. However, these proposals would be more complex to apply than the proposals in the 2010 ED. Accordingly, while the 2013 ED contained a complete draft of the proposed Standard on insurance contracts so that interested parties could consider the proposals in context, the IASB sought input only on the following five proposals:
- (a) That an entity should recognise any change in estimates relating to future service in the period in which the service is provided (ie to ‘unlock’ the contractual service margin); and
- (b) That there should be a measurement and presentation exception to reflect situations in which there can be no economic mismatches between the insurance contract and assets backing that contract.
- (c) That an entity should present insurance contracts revenue that is consistent with the principles for the revenue that is required by other IFRSs for other contracts with customers. Accordingly, an entity would depict the transfer of promised services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for

those services, measured as a reduction in the entity's performance obligations;

- (d) That an entity should present interest expense from insurance contracts in a way that enables an amortised cost-based expense to be presented in profit or loss and current-value-based measurement to be presented in the balance sheet.
- (e) That the transition approach should be amended to improve comparability for contracts originated before and after application of the proposals. The proposed transition approach specified some simplifications that maximise the use of objective data.

8. The IASB also sought input on whether the costs of implementing the proposed Standard would be justified by the benefits of the information provided overall. However, in publishing the 2013 ED, the IASB stated its intent that it would not revisit issues that it has previously rejected or reconsider consequences it has previously considered.

The accounting model proposed by the IASB

9. The 2013 ED proposes that an entity should measure insurance contracts using a current value approach that incorporates all of the available information in a way that is consistent with observable market information. As a result, the IASB has tentatively decided that the measurement of an insurance contract should incorporate a current, unbiased estimate of the cash flows expected to fulfill the liability, reflect the time value of money, risk and uncertainty and be calibrated at inception to the premium (except when onerous).
10. In addition, the 2013 ED proposed a presentation approach that would reflect (a) underwriting experience, the change in uncertainty and the profit from services in the period and, (b) through the interest and discount rate changes, both a current and a cost-based view of the cost of financing the insurance contract.
11. The IASB believes that the use of a current value measurement model for the insurance contracts liability is desirable for three important reasons:

- (a) It provides transparent reporting of changes in the insurance contract liability, including changes in the economic value of options and guarantees embedded in insurance contracts.
 - (b) It provides complete information about changes in estimates.
 - (c) It means that the assets and liabilities of an entity can be measured on a consistent basis¹, thus reducing accounting mismatch in comprehensive income and equity.
12. However, in a current measurement model, reported volatility can arise if there are economic or accounting mismatches. In other words, volatility arises:
- (a) if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. When such **economic mismatches** occur, market fluctuations give rise to real economic effects. When combined with a current measurement of the assets, a current measurement of the liability portrays those effects. This may result in reported volatility which the IASB believes faithfully represents the underlying economics.
 - (b) if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because they are measured on different bases. The IASB seeks to eliminate such **accounting mismatches**.
13. The extent of reported volatility arising from a current value approach was a critical issue in the feedback to the 2010 ED. The proposals in the 2013 ED would reduce the extent of reported volatility as follows:
- (a) The IASB confirmed that both a top-down and a bottom-up approach can achieve the objective of the discount rate and that the entity can decide which approach is best in its circumstances. The top-down approach significantly reduces accounting mismatch arising from the effect of credit spread changes by reflecting the effect of credit spread changes in both the asset and liability measurement.

¹ Ie assuming that assets are measured at fair value

- (b) The IASB decided to adjust (ie ‘unlock’) the contractual service margin for differences between current and previous estimates of cash flows relating to future coverage or other future services. This means that the effect of changes in estimates of cash flows would be reported over the remaining coverage period, rather in the period of change.
- (c) The IASB decided to present the changes in the insurance contract liability arising from changes in the discount rate in OCI, rather than in profit or loss.
- (d) The IASB decided that, for contracts which create a contractual link between the underlying items and the insurance contract liabilities, the measurement and presentation of the liabilities should mirror the measurement and presentation of the assets. Consequently, volatility arising from accounting mismatch is reduced for such contracts.
14. Nonetheless, volatility from both accounting and economic mismatches remains an important issue in the feedback on the 2013 ED, particularly for participating contracts.
15. As a consequence of these decisions, there is additional complexity in understanding how changes in estimates are treated under the model. The following table summarises the treatment of changes in estimates.

Type of change in estimate	Where recognised
Change in present value of cash flows relating to future service	Adjust contractual service margin, and recognised in profit or loss when future service provided
Change in present value of cash flows relating to past and current periods’ service (ie experience adjustments)	In profit or loss in the period of change (underwriting result)
Change in present value of cash flows unrelated to service (for example, some deposits)	In profit or loss in the period of change (net interest and investment)

Unwinding of discount based on discount rate at inception	In profit or loss in period of unwind (net interest and investment)
Effect of changes in discount rates on the measurement of liability	In other comprehensive income in the period of change
Changes in the risk adjustment (relating to current, past and future service)	In profit or loss in the period of change

Papers for this meeting

16. The agenda papers for this meeting consider insurance contracts revenue (one of the five targeted proposals in the 2013 ED) and the proposed plan for issues identified in the responses to the 2013 ED even though the IASB did not seek feedback on them. The papers on insurance contracts revenue consider only insurance contracts that have no participating features. Issues specific to participating contracts will be considered at a later stage, and, at that stage, the staff will consider whether the tentative decisions reached for non-participating contracts need to be revisited.

Insurance contracts revenue

17. Agenda Paper 2A *Insurance contracts revenue* and Agenda Paper 2B *Insurance contracts revenue - examples* should be read conjunctly. They discuss the proposals described in Question 3 of the 2013 ED to present in the statement of comprehensive income insurance contract revenue, rather than information about the changes in the components of the insurance contracts revenue:
- (a) Agenda Paper 2A considers whether an entity should present insurance contract revenue consistently for all insurance contracts, as proposed in the 2013 ED.
 - (b) Agenda Paper 2B describes the mechanics for determining insurance contracts revenue as proposed in the 2013 ED and illustrates the outcome of the insurance contracts revenue proposals for some types of contracts and illustrates the related disclosures.

18. The response in the comment letters to the proposals for insurance contract revenue was mixed. Many respondents who had a more generalist outlook supported the objective of consistent reporting for entities that issue insurance contracts. However, many with a more specialist outlook, including most preparers, did not agree that the presentation of insurance contract revenue would provide useful information. The most contentious issue for life insurers was the proposal that insurance contract revenue should exclude investment components, which are defined as amounts that the insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. Non-life insurers did not object to the proposals because it would not differ significantly from existing practice.
19. In Agenda Paper 2A, the staff recommends that the IASB confirm its 2013 ED proposal that:
- (a) an entity should be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue;
 - (b) entities should be *required* to present insurance contract revenue in the statement of comprehensive income, as proposed in paragraphs 56-59 and B88-B91 of the 2013 ED; and
 - (c) entities should disclose the following:
 - (i) a reconciliation that separately reconciles the opening and closing balance of the components of the insurance contract asset or liability (paragraph 76 of the 2013 ED).
 - (ii) a reconciliation from the premiums received in the period to the insurance contract revenue in the period (paragraph 79 of the 2013 ED);
 - (iii) the inputs used when determining the insurance contract revenue that is recognised in the period (paragraph 81(a) of the 2013 ED);
 - (iv) the effect of the insurance contracts that are initially recognised in the period on the amounts that are recognised in the statement of financial position (paragraph 81(b) of the 2013 ED); and

20. There are no staff recommendations in Agenda paper 2B.

Project plan for the non-targeted issues

21. Agenda Paper 2C *Project plan for the non-targeted issues* discusses the project plan for issues raised in the comment letters that were outside the five targeted areas. It does not discuss the drafting issues that were identified, which the staff will consider at a later stage of the project.
22. The staff analysed all comments received on the limited number of issues that fell outside the five targeted areas but omitted comments that were not pervasive and/or that may be addressed in drafting, including some issues that were identified in the January 2013 Agenda Paper 2A *Comment letter analysis*.
23. The staff recommends that the IASB should consider in future meetings the issues that the staff identified as requiring further analysis and may possibly need addressing. These issues relate to:
- (a) fixed fee service contracts;
 - (b) significant insurance risk guidance;
 - (c) portfolio definition and unit of account;
 - (d) discount rate for long term contracts and unobservable market data;
 - (e) asymmetrical treatment of reinsurance contracts;
 - (f) recognition of contracts acquired through the portfolio transfer or business combination; and
 - (g) allocation pattern for the contractual service margin (CSM).
24. The staff also identified issues that it recommends not to be considered in future meetings. These issues relate to:
- (a) disclosures;
 - (b) premium allocation approach;
 - (c) combination of insurance contracts;
 - (d) contract boundary for specific contracts;
 - (e) unbundling—lapse together criteria;

- (f) treatment of ceding commissions;
 - (g) discount rate—top-down and bottom-up approaches;
 - (h) tax included in the measurement; and
 - (i) combining the contractual service margin with other comprehensive income (OCI).
25. The details supporting the staff recommendations in paragraphs 24 and 25 are presented in Appendix A and Appendix B of the Agenda Paper 2C respectively.

Project progress and next steps

26. At this meeting the IASB will have addressed three of the five topics targeted in its 2013 ED as they apply to non-participating contracts. In future meetings the staff plans to:
- (a) address the issues not targeted in the ED that the IASB tentatively decides to address;
 - (b) consider the application of the model for non-participating contracts to contracts with participating features, including assessing any modifications that may be needed to reflect these features; and
 - (c) consider transition in the context of a near final model.
27. The IASB expects that redeliberations of its proposals for the accounting for insurance contracts will be completed in 2014, with the publication of a final Standard following in 2015. A more exact timetable will depend on decisions the IASB takes in Agenda Paper 2C relating to the project plan for other issues.

Appendix A: Summary of changes from the 2013 ED

The following table presents a summary of changes from the 2013 ED.

Proposal in the 2013 ED	Confirmed principle	Revision of the 2013 ED proposal
Changes in discount rate presented in OCI	✓	Accounting policy choice at portfolio level for the effect of changes in discount rate to be presented in P&L or OCI Disclosures that would disaggregate the change in interest expense into its component parts and that would allow their comparison
Unlocking the CSM	✓	Changes in estimates of risk adjustment relating to future service also recognised in period when service is provided Reversal of previously recognised losses before margin is rebuilt
Insurance contracts revenue	TBD	TBD
Mirroring approach	TBD	TBD
Transition	TBD	TBD

Appendix B: Tentative decisions to date

The following table presents a summary of tentative decisions made in the redeliberations phase in 2014:

Tentative decisions	Follow up
1. Unlocking the contractual service margin	
<p>(a) Differences between the current and previous estimates of the present value of cash flows and the risk adjustment related to future coverage and other future services should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative.</p> <p>(b) Differences between the current and previous estimates of the present value of cash flows and the risk adjustment that do not relate to future coverage and other future services should be recognised immediately in profit or loss.</p> <p>(c) Favourable changes in estimates that arise after losses were previously recognised in profit or loss should be recognised in profit or loss to the extent that they reverse losses that related to coverage and other services in the future.</p>	<ul style="list-style-type: none"> • Interaction between unlocking contractual service margin and use of OCI • Application to contracts with participating features
2. Recognising the effects of changes in the discount rate in other comprehensive income	
<p>(a) An entity should choose to present the effect of changes in discount rates in profit or loss, or in other comprehensive income as its accounting policy and should apply that accounting policy to all contracts within a portfolio</p> <p>(b) If the entity chooses to present the effect of changes in discount rates in other comprehensive income, the entity should:</p> <p>(i) Recognise in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised; and</p>	<ul style="list-style-type: none"> • Whether there should be guidance that entities should apply the same accounting policy to groups of similar portfolios and the interaction with the definition of a portfolio • More guidance on when an entity can change its accounting policy choice based on the requirements for

<p>(ii) Recognise in other comprehensive income, the differences between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract was initially recognised.</p> <p>(iii) Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum to:</p> <ol style="list-style-type: none"> 1. interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in profit or loss for the period; and 2. the movement in other comprehensive income for the period. <p>(c) An entity should disaggregate total interest expense included in total comprehensive income to:</p> <ol style="list-style-type: none"> (i) the amount of interest accretion determined using current discount rates (ii) the effect on the measurement of the insurance contract of changes in discount rates in the period; and (iii) the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the contractual service margin when measured at current rates. 	<p>changing accounting policy in IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>.</p> <ul style="list-style-type: none"> • Interaction between unlocking the contractual service margin and use of OCI • Application to contracts with participating features
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