STAFF PAPER

June 2014

REG IASB Meeting

Project	**Insurance contracts**		
Paper topic	Cover note		

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Purpose of paper

1. This paper provides:

   (a) a reminder of the objectives of the Insurance Contracts project (paragraphs 3-5);

   (b) an overview of the papers for the June 2014 meeting, together with a summary of the staff recommendations (paragraphs 6-15); and

   (c) a summary of project progress and next steps (paragraphs 16-19)

2. This paper contains the following appendices:

   (a) Appendix A, which describes the input sought in the IASB's 2013 Exposure Draft *Insurance Contracts* ('the 2013 ED');

   (b) Appendix B, which provides an overview of the accounting model proposed by the IASB; and

   (c) Appendix C, which summarises the IASB's tentative decisions to date that would amend the proposals in the 2013 ED.

Objectives of the insurance contracts project

3. At present, IFRS has no comprehensive standard that deals with the accounting for insurance contracts. IFRS 4, the interim Standard for insurance contracts published in 2004, carried forward a wide range of existing diverse practices.

IFRS 4 also included 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 losses through underwriting activity 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.

5. Appendix B describes the IASB’s proposals in more detail.

Papers for this meeting

6. The agenda papers for this meeting consider :

(a) the remaining issues that were not targeted for input in the 2013 ED, that the IASB nonetheless agreed to reconsider; and

(b) the accounting for contracts with participating features, one of the issues targeted for input in the 2013 ED.

Non-targeted issues

Determining discount rates when there is lack of observable data

7. The 2013 ED proposed that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract. Agenda Paper 2A *Determining discount rates when there is lack of observable data* considers whether the IASB should provide additional application guidance on how an entity should apply that principle.

8. In Agenda Paper 2A the staff recommend that the IASB:

   (a) Confirm the principle that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract;

   (b) Provide additional application guidance that, in determining those discount rates, an entity should use judgment to:

      (i) Ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured; and

      (ii) Develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly any unobservable inputs should not contradict any available and relevant market data.

Non-targeted issues – Asymmetrical treatment of gains from reinsurance contracts

9. Agenda Paper 2B *Non-targeted issues – Asymmetrical treatment of gains from reinsurance contracts* considers whether there should be an exception to the proposal in the 2013 Exposure Draft *Insurance Contracts* that a favourable change

in cash flows of a reinsurance contract held by an entity should be recognised in profit or loss over the coverage period, if those cash flows reimburse the entity for losses that arise from underlying insurance contracts that are onerous.

10. In the Agenda Paper 2B the staff recommend that an entity should recognise in profit or loss any changes in estimates of cash flows for a reinsurance contract that arises as a result of changes in estimates of cash flows for an underlying direct insurance contract that are recognised immediately in profit or loss.

Non-targeted issues – Level of aggregation

11. Agenda Paper 2C *Non-targeted issues – Level of aggregation* Agenda Paper 2C *Non-targeted issues – Level of aggregation* discusses the levels of aggregation that an entity can use to achieve the objective of measuring an insurance contract and the reference to pricing in the definition of a portfolio. Furthermore, in the light of the March 2014 Board's decision on presenting effect of changes in the discount rate in other comprehensive income, the paper proposes additional requirements for when an entity selects the accounting policy to apply to portfolios of insurance contracts.

12. In the Agenda Paper 2C *Non-targeted issues – Level of aggregation* the staff recommend that the IASB:

    (a) clarify that the objective of the proposed insurance contracts standard is to provide principles for the measurement of an individual insurance contract, but that in applying the standard an entity could aggregate insurance contracts provided that it meets that objective.

    (b) amend the definition of a portfolio of insurance contracts to be:

        "insurance contracts that provide coverage for similar risks and are managed together as a single pool".

    (c) add guidance to the proposed Standard that:

        (i) in determining the contractual service margin or loss at initial recognition, an entity should not combine onerous contracts with profit-making contracts. An entity should consider the facts and circumstances to determine whether a contract is onerous at initial recognition, i.e. whether the sum of the fulfilment cash flows and

any pre-coverage cash flows determined for the contract is greater than zero;

(ii) in determining the contractual service margin at subsequent measurement an entity could combine contracts that have similar:

1. release patterns;
2. absolute amounts of contractual service margin at initial recognition; and
3. inception dates and coverage periods.

(d) clarify that, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, an entity should select and apply its accounting policies consistently for similar contracts, considering the portfolio in which the contract is included and the related assets that the entity holds.

Targeted issues

The identification of underlying items

13. Agenda paper 2D *The identification of underlying items* continues the IASB's discussions of the adaptations that might be needed for contracts with participating features. In that paper, the staff recommend:

(a) If the IASB were to require an entity to adjust the contractual service margin for the insurer's share of the underlying items on the grounds that the insurer's share represents an implicit management fee, an implicit asset management fee should be considered to exist only when:

(i) The returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders);

(ii) there is a minimum amount (either fixed or determinable) that the entity must retain; and

(iii) the policyholder will receive a substantial share of the total return on underlying items.

(b) If the IASB were to require an entity to apply a book yield approach for determining the interest expense presented in profit or loss, a book yield approach should be considered appropriate only when:

(i) The returns passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items); and

(ii) The policyholder will receive a substantial share of the total return on underlying items.

14. In addition, the staff ask the IASB for their views on the amount that would adjust the contractual service margin and on the mechanics of the book yield approach.

15. The staff will ask the IASB to confirm all tentative decisions taken at this meeting when considering all the decisions relating to contracts with participating features as a whole.

Project progress and next steps

16. The IASB has substantially completed its discussions on the model for contracts that do not have participating features. Remaining topics to discuss for such contracts include:

(a) the discount rate to be used to determine the present value of cash flows that adjust the contractual service margin and used to accrete interest on the contractual service margin;

(b) follow up issues relating to other comprehensive income and premium allocation approach; and

(c) transition and effective date.

17. Appendix C summarises the IASB’s tentative decisions to date.

18. The IASB plans to continue its discussions on the adaptations to its tentative decisions to that would be needed for contracts with participating features over the coming months.

19. 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 in 2015.

Appendix A: The approach in the IASB's 2013 Exposure Draft *Insurance contracts*

A1. 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.

A2. The feedback received on the IASB's earlier documents confirmed that there was widespread acceptance of the proposal to measure insurance contracts using a current, market-consistent approach. 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.

A3. 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);

(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; and

(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.

A4. 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.

Appendix B: The accounting model proposed by the IASB

Contracts with no participating features

B1. 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. That approach measures an insurance contract in a way that incorporates the following:

(a) a current, unbiased estimate of the cash flows expected to fulfill the insurance contract. The estimate of cash flows reflects the perspective of the entity, provided that the estimates of any relevant market variables do not contradict the observable market prices for those variables.

(b) An adjustment for the time value of money, using discount rates that reflect the characteristics of the cash flows. The discount rates are consistent with observable current market prices for instruments with cash flow characteristics are consistent with those of the insurance contract and exclude the effect of any factors that influence the observable market prices but that are not relevant to the cash flows of the insurance contract.

(c) An adjustment for the effects of risk and uncertainty. The risk adjustment is defined as being the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract.

B2. The underlying objective of this approach is to achieve a valuation of the insurance contract, including any options and guarantees embedded in the insurance contract, in a manner that is consistent with market information. However, the measurement of insurance contracts is a current expected value measurement rather than a fair value measurement. This reflects the IASB's conclusion that the fact that insurance contracts are not traded in active markets means that fair value would not be an appropriate measurement attribute for insurance contracts. Consequently, the valuation approach proposed by the IASB takes into account the fact that an entity

expects to fulfil the contracts, rather than transfer them. That approach differs from fair value measurement in the following main areas:

(a) It does not reflect the non-performance risk of the entity that issues the insurance contract. In other words, the credit risk of the entity that issues the contract is not reflected in the measurement (paragraph 21 of the 2013 ED).

(b) The risk adjustment reflects the entity's—and not a market participant's—perception of the effects of uncertainty about the amount and timing of cash flows that arise from an insurance contract (paragraph B76 of the 2013 ED).

(c) A contractual service margin is recognised at inception, and allocated after inception (paragraph 32 of the 2013 ED), rather than being remeasured in a way that reflects a market participant's viewpoint.

(d) The measurement of an insurance contract does not have the equivalent of the requirement in paragraph 47 of IFRS 13 *Fair Value Measurement* that the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

B3. 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 basis[1], thus reducing accounting mismatch in comprehensive income and equity.

[1] Ie assuming that assets are measured at fair value.

B4. However, the measurement approach in the 2013 ED reflects the IASB's view of an insurance contract as combining the features of both a financial instrument and a service contract and thus the IASB does not propose a fair value measurement for the insurance contract. Because the service component and the financial instrument component of the contractual are interrelated, the IASB does not propose that the components should be unbundled and accounted for separately. However, the IASB's model aims to ensure as much consistency as possible between the features of each component and the standalone component, had it been reported separately. As a result, the IASB's model treats changes in estimates relating to the two components differently:

(a) The entity accounts for changes in estimates relating to the service component in a way similar to the effect that would be achieved if the entity had applied the revenue recognition model to the component. As a result, changes in estimates relating to future service adjust the contractual service margin and are recognised in profit or loss when the related service is provided. Changes in estimates related to current or past periods' service would be recognised in profit or loss.

(b) The entity accounts for changes in estimates relating to the financial component in a way similar to the effect that would be achieved if the entity had applied the financial instruments model to the component. As a result, changes in estimates relating to the financial estimates are recognised in profit or loss or other comprehensive income.

B5. 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 result).
Unwinding of discount based on discount rate at inception.	In profit or loss in period of unwind (net interest and investment result).
Effect of changes in discount rates since inception of the contract on the measurement of liability.	In other comprehensive income in the period of change.
Changes in the risk adjustment relating to current and past future service.	In profit or loss in the period of change.
Changes in the risk adjustment relating to future service.	Adjust contractual service margin, and recognised in profit or loss when future service provided.

Presentation approach

B6. The 2013 ED proposed a presentation approach for the statement of comprehensive income that would:

(a) align the presentation of revenue and expense with that required for other contracts with customers. This would make the financial statements of entities that issue insurance contracts easier to understand for generalist users of those financial statements.

(b) provide information about the main sources of profits for entities that issue insurance contracts.

(c) provide both a current and a cost-based view of the cost of financing the insurance contract. This would provide disaggregated information about the effects of changes in discount rates on the financial statements of entities that issue insurance contracts.

Applying the general proposals in the 2013 ED to contracts with participating features

B7. The staff's approach for contracts with participating features is to consider the adaptations that would be needed if the general proposals in the 2013 ED were to be applied to contracts with participating features. The Board's tentative decisions to date would apply to contracts with participating features as follows:

(a) the cash flows include the expected cash flows that arise from the returns of the underlying items that the entity expects to be passed to the policyholder. This has two important consequences:

(i) when a contract provides an entity with discretion over the timing and/or amount of the returns from underlying items that are passed to policyholders, the fulfilment cash flows includes the cash flows that are subject to the entity's discretion. The IASB viewed such payments as arising out of the obligation in the contract to share in the returns of the underlying items with the policyholder.

(ii) the fulfilment cash flows reflect the returns to be passed to the policyholder, even if the entity invests in underlying items that generate a different return. When that is the case, the difference between the returns on the entity's investments and the returns to be paid to policyholders provides useful information to investors on the economic mismatches arising between the items held by the entity and the entity's obligations arising from the contract. In such cases, because the underlying items generate a different return they do not impact the cash flows of the insurance contract.

(d) the discount rates used to adjust those cash flows for the time value of money should reflect the extent of dependence of the amount, timing or uncertainty of the cash flows that arise from the insurance contract on the returns on underlying items. This ensures consistency between the cash flows and the discount rates used to adjust those cash flows for the time value of money.

(e) The risk adjustment would reflect the compensation the entity would require for bearing the uncertainty about those cash flows. No adaptations are needed for the risk adjustment.

(f) The contractual service margin would be determined at initial recognition to eliminate any day 1 gain. Subsequent to initial recognition, the contractual service margin would be adjusted to reflect changes in estimates that relate to future services.

(g) Interest expense would be reported in profit or loss using discount rates that are determined at the date when the contract was initially recognized, updated to reflect changes in returns on underlying items that are expected to affect the amount of cash flows to the policyholder.

Appendix C: Tentative decisions to date

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

Tentative decisions	Change from 2013 ED	Follow up
1. Unlocking the contractual service margin		
(a) Differences between the current and previous estimates of the present value of expected 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. (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. (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 to be provided in the future.	The 2013 ED would: • recognise all changes in estimates of risk adjustment immediately in profit or loss. • rebuild the contractual service margin from zero without first reversing previously recognised losses in the profit or loss.	• Interaction between unlocking contractual service margin and use of OCI. • Application to contracts with participating features.

<table>
<tr><th>Tentative decisions</th><th>Change from 2013 ED</th><th>Follow up</th></tr>
<tr><td colspan="3">2. Recognising the effects of changes in the discount rate in other comprehensive income</td></tr>
<tr><td>(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
(b) If the entity chooses to present the effect of changes in discount rates in other comprehensive income, the entity should:
(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
(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.
(iii) Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum to:
1. interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in</td><td>The 2013 ED proposed that the effect of changes in discount rates should be required to be presented in OCI.</td><td>• 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 (see Agenda Paper 2C Non-targeted issues: Level of aggregation for this meeting).
• More guidance on when an entity can change its accounting policy choice based on the requirements for changing accounting policy in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.
• Interaction between unlocking the contractual</td></tr>
</table>

Tentative decisions	Change from 2013 ED	Follow up
profit or loss for the period; and 2. the movement in other comprehensive income for the period. (c) An entity should disaggregate total interest expense included in total comprehensive income to: (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.		service margin and use of OCI. • Application to contracts with participating features.
3. Presenting insurance contracts revenue and expense in the statement of comprehensive income		
(d) An entity should present insurance contract revenue and expense in the statement of comprehensive income, as proposed in paragraphs 56–59 and B88–B91 of the 2013 ED; and	The 2013 ED did not explicitly prohibit presenting premium	• Application to contracts with participating features

Tentative decisions	Change from 2013 ED	Follow up
(e) An entity should disclose the following: (i) a reconciliation that separately reconciles the opening and closing balances 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); and (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). (f) 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.	information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue.	

Tentative decisions		Change from 2013 ED	Follow up
4. Non-targeted issues			
(a)	level of aggregation and portfolio definition	-	See Agenda Paper 2C *Non-targeted issues: Level of aggregation* for this meeting
(b)	discount rate for long-term contracts when there is little or no observable market data	-	See Agenda Paper 2A *Determining discount rates when there is lack of observable data* for this meeting
(c)	asymmetric treatment of contractual service margin between insurance contracts issued and reinsurance contracts held	-	See agenda paper 2B *Non-targeted issues – Asymmetrical treatment of gains from reinsurance contracts* for this meeting
(d)	allocation of the contractual service margin to the profit or loss i. confirm the principle in the 2013 ED that an entity should recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services that are	The 2013 ED stated that an entity should recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the	Application to contracts with participating features

Tentative decisions	Change from 2013 ED	Follow up
provided under an insurance contract. ii. clarify that, for contracts with no participating features, the service represented by the contractual service margin is insurance coverage that: 1. is provided on the basis of the passage of time; and 2. reflects the expected number of contracts in force.	remaining transfer of the services that are provided under an insurance contract.	
(e) significant insurance risk i. clarify the guidance in paragraph B19 of the 2013 ED that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis.	Paragraph B19 of the 2013 ED stated that: In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.	None

Tentative decisions	Change from 2013 ED	Follow up
(f) portfolio transfers and business combinations i. clarify the requirements for the contracts acquired through a portfolio transfer or a business combination in paragraphs 43-45 of the 2013 ED, that such contracts should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or business combination.	All the requirements in the 2013 ED applied to insurance contracts acquired through a portfolio transfer or a business combination. The 2013 also included additional specific requirements regarding accounting for such contracts.	None
(g) fixed fee service contracts i. that entities should be permitted, but not required, to apply the revenue recognition Standard to the fixed-fee service contracts that meet the criteria stated in paragraph 7(e) of the 2013 ED.	The 2013 ED excluded fixed fee service contracts from its scope.	None
(h) In April 2014 the IASB tentatively decided not to consider in future meetings other non-targeted issues, including those relating to: (i) disclosures; (ii) premium allocation approach; (iii) combination of insurance contracts; (iv) contract boundary for specific contracts; (v) unbundling—lapse together criteria;	None	None

Tentative decisions	Change from 2013 ED	Follow up
(vi) treatment of ceding commissions; (vii) discount rate—top-down and bottom-up approaches; (viii) tax included in the measurement; and (ix) combining the contractual service margin with other comprehensive income.		