STAFF PAPER

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Project	**Insurance contracts**		
Paper topic	Overview of the new insurance contracts Standard		

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Purpose of this paper

1. This paper provides an overview of the features of insurance contracts and the accounting models the International Accounting Standards Board (the Board) has developed for the recognition, measurement and presentation of them. It provides background information and does not offer any staff recommendations.

2. This paper describes:

   (a) key features of insurance contracts in paragraphs3-5; and

   (b) the accounting model for insurance contracts, including a discussion on the measurement, presentation and disclosures in paragraphs 6-26.

Key features of insurance contracts

3. The Board defines an insurance contract as "A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder".

4. The defining feature of an insurance contract is therefore the transfer of significant insurance risk. It can be difficult to account for contracts with significant insurance risk because of the uncertainty associated with whether or

when an insured event will occur, and how much the issuer will be required to pay if the insured event does occur.

5. Furthermore, some insurance contracts have features other than the transfer of significant insurance risk, including:

   (a) promised payments that do not arise on the occurrence of an insured event. Such payments may provide policyholders with a combination of an investment-like return, guaranteed payments or payments that depend on the performance of specified items;

   (b) payments that are subject to the entity's discretion or constrained discretion;

   (c) options that allow the policyholder to change the basis on which payments are determined;

   (d) rights and obligations that are interdependent; and

   (e) renewal options that bind the issuer, but not the policyholder.

The Board's accounting model for insurance contracts

6. The accounting model for insurance contracts developed by the Board is intended to provide comparable, transparent information about the effect of issuing insurance contracts on an entity's financial position and performance.

7. To achieve this, the Board's model would require an entity:

   (a) to measure the obligations that arise as a result of issuing the insurance contracts in a way that reflects the uncertainty over the timing and amount of expected future cash flows arising from the contract. Those obligations comprise both:

      (i) an obligation to pay net future cash outflows, represented by the fulfilment cash flows; and

      (ii) an obligation to provide insurance coverage over the coverage period (ie a performance obligation), represented by the contractual service margin.

(b) to report the profits arising from insurance contracts in a way that reflects the nature of the activity that the entity undertakes to generate that profit; and

(c) to disclose information that helps users of financial statements to understand the amounts reported in financial statements, and that provides information about the nature and extent of risks that an entity is exposed to as a result of issuing insurance contracts.

8. In developing its model, the Board has had the objective of avoiding accounting mismatches between insurance contracts and related assets, while ensuring that the effects of economic mismatches are reported:

(a) An *accounting mismatch* arises 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, for example because of different measurement bases for assets and liabilities.

(b) In contrast, an *economic mismatch* arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions.

9. To achieve this objective, the Board:

(a) believes that a current measurement approach for insurance contracts is superior to a cost measurement approach.

(b) accounts for insurance contracts separately from assets that an entity holds, except in the limited circumstances described in paragraph 20.

(c) enabled entities to adopt a presentation approach that minimises accounting mismatches in profit or loss when assets are measured using different bases, in particular:

(i) by permitting an entity to choose as its accounting policy choice to recognise the effects of financial market variables solely in profit or loss or disaggregated between profit or loss and OCI; and

(i) for contracts with participation features, providing optional exceptions when accounting mismatches may arise.

10. A current measurement approach is more likely to allow entities to minimise accounting mismatches in the statement of comprehensive income and equity. Accounting for the insurance contracts separately from assets that an entity holds makes transparent economic mismatches between those contracts and those assets.

Measurement approach

11. The underlying objective of the Board's approach is to achieve a valuation of an insurance contract in a manner that is consistent with market information. That valuation would include any financial options and guarantees embedded in the insurance contract. The Board believes that the use of a market-consistent current value measurement model for the insurance contracts liability is desirable for three reasons:

    (a) it provides complete information about changes in estimates, ie it incorporates all of the available information in a way that is consistent with observable market information.

    (b) 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.

    (c) it means that the assets and liabilities of an entity can be measured on a consistent basis[1], thus reducing accounting mismatches in comprehensive income and equity.

12. However, the measurement of insurance contracts is a current expected value measurement rather than a fair value measurement. This reflects the Board's conclusion that fair value would not be an appropriate measurement attribute for insurance contracts because insurance contracts are usually settled by satisfaction of the obligation, rather than traded. Consequently, the valuation approach proposed by the Board takes into account the fact that an entity expects to fulfil the contracts, rather than transfer them.

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[111] That is assuming that those assets are measured at fair value.

13. The measurement approach also reflects the Board's view that an insurance contract combines the features of both a financial instrument and a service contract. When the service component and the financial instrument component of the contract are interrelated, which is likely to be the majority of contracts, the Board does not propose that the components should be unbundled and accounted for separately. Thus the whole insurance contract is measured at initial recognition in a way that incorporates the following:

    (a) a current, unbiased estimate of the cash flows expected to fulfil 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 that 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.

    (d) an amount that reflects the excess of the consideration charged for the contract over the risk-adjusted expected present value of the cash outflows expected to arise as the entity fulfils the contract (referred to as the contractual service margin). The model assumes that any excess of the consideration over the expected cash outflows is a measure of the value of the service the entity would perform in fulfilling the contract. Accordingly the contractual service margin means that the entity would not recognise that excess as an immediate gain, but would instead

recognise that gain as the entity satisfied its obligation to provide service over the coverage period.

14. Together (a), (b) and (c) are referred to as the fulfilment cash flows.

15. After initial recognition, the entity remeasures the fulfilment cash flows (ie the risk-adjusted present value of the cash flows expected to arise as the entity fulfils the contract). However, the Board believes that changes in the different types of estimates on the fulfilment cash flows should have a different effect on the fulfilment cash flows, depending on their nature. Accordingly, the Board's model aims to reflect the different information value from changes in different types of estimates in a way that is consistent with the accounting that would have resulted if a component reflecting only those estimates would have been reported, had it been reported separately.

16. Consequently:

    (a) the contractual service margin is adjusted as follows:

        (i) favourable and unfavourable differences between current and previous estimates of the present value of cash flows (determined using the rate at inception) and the risk adjustment that relate to future service are absorbed in the contractual service margin, subject to the contractual service margin not being negative.

        (ii) an allocation of the contractual service margin is recognised in profit or loss as the entity provides service under the insurance contract.

        (iii) interest is accreted on the contractual service margin, using the rate at inception of the contract.

    (b) The remaining effects of remeasuring the fulfilment cash flows are recognised in the statement of comprehensive income. In particular:

        (i) changes in estimates relating to the financial market variables, including the effects of changes in discount rates, are recognised all in profit or loss or disaggregated between profit or loss and other comprehensive income (OCI) in the period in which the change occurs.

(ii) Changes in estimates relating to the current period and past period services are recognised in profit or loss.

17. As a result:

(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 that component.

(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 that component.

The variable fee approach

18. In the Board's general model, all changes in cash flows that arise from financial market variables are considered as financial components. Accordingly, those changes are recognised all in profit or loss or disaggregated between profit or loss and OCI.

19. However, at the June 2015 Board meeting, the Board decided that it would modify the general measurement model for specified insurance contracts with participation features, reflecting the view that some insurance contracts create an obligation to pay to policyholders an amount that is equal in value to specified underlying items, less a variable fee for service. That approach is referred to as the 'variable fee approach'. Applying the variable fee approach:

(a) The entity's obligation to the policyholder is considered to be the net of:

(i) the obligation to pay the policyholder an amount equal to the fair value of the investment portfolio (referred to as 'underlying items'); and

(ii) a variable fee that the entity deducts in exchange for the services provided by the insurance contract.

The staff notes that the underlying items are not the items that the entity holds. Rather, they are referenced items, on which the obligation is based.

(b) Changes in the estimate of the obligation to pay to the policyholder an amount equal to the fair value of the underlying items would be

recognised in the statement of comprehensive income. (This is includes the implicit accretion of the contractual service margin at current rates).

(c) 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. Accordingly, such changes in estimates, which may reflect changes in financial market variables, are regarded as relating to service, and 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.

20. The Board considered that the variable fee approach would produce representationally faithful information for only the following specified contracts (termed contracts with direct participation features):

(a) the contractual terms specify that the policyholder participates in a 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.

Differences between the general model and the variable fee approach

21. The variable fee approach and the general model produce the same measurement for insurance contracts, except for:[2]

(a) the recognition of the effect of changes in financial market variables on financial guarantees embedded in insurance contracts:

(i) under the general model, these changes are recognised in the statement of comprehensive income; and

(ii) under the variable fee approach, these changes mostly adjust the contractual service margin.

[2] There is also a difference in presentation in profit or loss and OCI for some insurance contracts under the variable fee approach that qualify for the current period book yield presentation.

(b) measurement of the contractual service margin after initial recognition:

(i) under the general model, the contractual service margin is accreted at a locked-in discount rate at inception and any adjustments for the present value of cash flows relating to future service are measured at the same locked-in discount rate; and

(ii) under the variable fee approach, the contractual service margin is remeasured using current discount rates. Consequently, the contractual service margin is implicitly accreted and adjusted using current discount rates.

22. At its November 2015 Board meeting, the Board has decided that it would not amend the variable fee approach or the general model to eliminate these differences.

23. The Appendix summarises the accounting for different types of contracts within the scope of the new insurance contracts Standard.

Presentation approach

24. The Board's presentation approach for the statement of comprehensive income is to:

(a) align the presentation of revenue and expense with that required for other contracts with customers. In particular, revenue would reflect the value of service in the current period and exclude the receipt of deposit-like amounts, and expenses would reflect the costs incurred to provide services in the current period and exclude the repayment of deposit-like amounts. This would make the financial statements of entities that issue insurance contracts easier to understand for generalist users of those financial statements, and eliminate existing presentation differences between life and non-life contracts.

(b) provide information about the main sources of profits for entities that issue insurance contracts. In particular, the requirements would identify an underwriting result that reflects the profit for the provision of insurance services for the period, separate from the investing result. This would make the drivers of financial performance of insurance

contracts more transparent than the existing practice for many insurance contracts.

(c) provide both a current and a cost-based view of the cost of financing an insurance contract. This would provide disaggregated information about the effects of changes in discount rates on the financial results of entities that issue insurance contracts. This would allow entities to choose an accounting policy that provide relevant reporting of their financial performance.

Disclosures

25. The information in the financial statements would be supplemented by comprehensive disclosures that would require the entity to explain:

(a) the judgements needed in arriving at the amounts recognised in the financial statements;

(b) the changes in the components of the insurance contracts measurement, including a reconciliation in the amounts presented in the statement of comprehensive income; and

(c) the nature and extent of risks arising from insurance contracts.

Other matters

26. The Standard for insurance contracts also addresses other matters, including

(a) adaptations for different types of contract with the scope of the new Standard, as follows*:*

(b) an optional simplified measurement approach for simpler insurance contracts (ie Premium Allocation Approach (PAA), based on the unearned premium reserve approach used in many jurisdictions. The simplified measurement approach results in outcomes consistent with IFRS 15 *Revenue from Contracts with Customers* as well as with the general model.

(c) accounting requirements for reinsurance contracts that an entity holds, based on the general model. The net reinsurance contract position would represent the right to future receipts under the reinsurance contract, net of the future cost of obtaining reinsurance services. The amounts received and paid under reinsurance contracts held would reflect the income and expense of the contract, and is reported consistently with income and expense from other sources.

(d) accounting requirements for investment contracts with discretionary participating features to reflect that these contracts provide asset management services instead of insurance coverage.

Appendix:

This Appendix summarises the accounting for different types of contracts within the scope of the new insurance contracts Standard.

	Non-participating contracts accounted for using PAA	**Non-participating contracts accounted for using the general model**	**Participating contracts accounted for using the general model**	**Participating contracts accounted for using the variable fee approach**
Initial measurement	Measure the part of the insurance contract representing the liability for remaining coverage at the expected premium.. Measure the part of the insurance contract representing the liability for incurred claims using fulfilment cash flows.	Measure fulfilment cash flows using a current, unbiased estimate of the cash flows expected to fulfil the insurance contract, adjusted for the time value of money and the effects of risk and uncertainty. Measure the contractual service margin (CSM) as any excess of the expected consideration charged for the contract over the risk-adjusted expected present value of the cash flows expected to arise as the entity fulfils the contract.		
Subsequent measurement – adjustment of contractual service margin - **Principle**	Not applicable --for liability for remaining coverage, estimates are not remeaured. For liability for incurred claims, there is no remaining CSM to adjust.	**Adjust the contractual service margin for changes in estimates relating to the service component provided in future periods.**		
- Changes in estimates of non-financial assumptions		Treated as relating to service: - Those relating to future periods adjust the CSM. - Those relating to current and past periods are recognised in profit or loss.		
- Change in estimate of how the entity expects to exercise discretion		Treated as a non-financial assumption, ie relating to service. In November paper consider how to distinguish the effect of changes in financial assumptions from effect of changes in estimates of discretion.		
- Changes in estimates of financial assumptions		Treat as unrelated to service, ie recognise in SCI. - For non-participating contracts the only change in financial market assumptions is the change in discount rate. - For participating contracts, financial market assumptions can also affect the estimate of cash flows to be paid to the policyholders. Changes in estimates of financial assumptions includes the changes in estimate of value of embedded financial guarantees.		The changes in financial market assumptions are treated as part of the fee for service to the extent that they do not affect the underlying items. Thus, those changes are adjusted in contractual service margin (through remeasurement of the contractual service margin). (100% change of the fair value of the underlying items is recognised in the statement of comprehensive income).
- Remeasurement of CSM	Not applicable	No.		Yes.

<table>
<tr><th></th><th>Non-participating contracts accounted for using PAA</th><th>Non-participating contracts accounted for using the general model</th><th>Participating contracts accounted for using the general model</th><th colspan="2">Participating contracts accounted for using the variable fee approach</th></tr>
<tr><td>Rate for accretion of interest and determining the present value of cash flows adjusting the CSM</td><td colspan="3">At the locked- in rate at inception.</td><td colspan="2">At current rate, through remeasurement of CSM.</td></tr>
<tr><td>Subsequent measurement – recognition of contractual service margin in profit or loss</td><td>Implicitly reflected when the unearned premium is recognised in profit or loss – on a straight line basis.</td><td colspan="4">Recognised on basis of provision of insurance coverage (straight line)</td></tr>
<tr><td rowspan="2">Insurance investment expense in profit or loss, if OCI accounting policy</td><td rowspan="2">None recorded for liability for remaining coverage (implicit in the allocation of unearned premium)
For liability for incurred claim, interest determined using rates at the date the claim was incurred.</td><td colspan="3">Insurance investment expense determined on a ‘cost’ basis</td><td rowspan="2">Insurance investment expense determined using current period book yield approach, which eliminates accounting mismatch with items held in profit or loss</td></tr>
<tr><td>Generally there are no variable cash flows, and the entity would determine insurance investment expense on a cost basis using locked in discount rates.</td><td colspan="2">Apply an appropriate version of effective yield approaches</td></tr>
<tr><td>Amounts in OCI</td><td colspan="5">Difference between the insurance investment expense in profit or loss and the insurance investment expense determined using a current rate</td></tr>
</table>