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# IFRS Project Insights
# Insurance Contracts

The International Accounting Standards Board ("IASB"/ "the Board") is undertaking a comprehensive project on the accounting for insurance contracts, with the objective of developing a comprehensive standard that will address recognition, measurement, presentation and disclosure requirements.

The Board issued a Discussion Paper ("DP") *Preliminary Views on Insurance Contracts* in May 2007. In August 2010, the Board issued Exposure Draft ED/2010/8 *Insurance Contracts* ('the 2010 ED').

On 20 June 2013, the Board issued revised Exposure Draft ED/2013/7 *Insurance Contracts* ("the 2013 ED") which included changes in the insurance accounting proposals in response to the concerns raised by the insurance industry and other stakeholders on the 2010 ED. The Board decided to seek comments only on the 5 targeted areas where significant changes have been made since the 2010 ED. These are:

i. unlocking the contractual service margin ("CSM") to reflect changes in cash flows for future coverage and/or services;

ii. splitting interest expense between profit or loss and other comprehensive income ("OCI solution");

iii. presenting insurance contract revenue and expenses;

iv. measuring and presenting cash flows from contracts with a contractual link to underlying items ("mirroring approach"); and

v. transition provisions for the first application of the standard with a modified retrospective application of all the new requirements.

The comment period for the 2013 ED closed on 25 October 2013.

The Board also conducted fieldwork that was undertaken by 17 participants from jurisdictions other than the European Union ("EU") and 13 participants from the EU as coordinated with the European Financial Reporting Advisory Group ("EFRAG") and the French, German, United Kingdom and Italian national standard-setters. The Board also conducted 44 discussions with 159 users of financial statements from various jurisdictions worldwide between June and December 2013.

## Convergence

On October 2008, the IASB and the Financial Accounting Standards Board ("FASB") agreed to undertake the project on insurance contracts jointly and have held several joint meetings from 2008 until the publication of the 2013 ED by the IASB and the Proposed Accounting Standards Update ("ASU") by the FASB on 20 June 2013.

A joint meeting by the IASB and the FASB was held in January 2014 to consider the respective Staff summaries of the feedback received from users of financial statements and outreach activities. The discussions highlighted the key areas of concerns from the respondents on the respective IASB and FASB proposals. No decisions were required during that meeting.

Following this joint meeting, the FASB had a separate redeliberation meeting on 19 February 2014 where it decided to take a new course for its insurance contracts project. The FASB's new direction is to substantially preserve the current U.S. pronouncements affecting insurance entities and to identify and release an ASU which will introduce only certain targeted amendments.

## Tentative decisions in redeliberating the 2013 ED

**Topics discussed at the 25 April 2014 IASB meeting:**

- **Insurance contract revenue**: discussion on whether an entity should present insurance contract revenue consistently for all insurance contracts and whether the cost of providing insurance contract revenue is justified for all insurance contracts.

- **Non-targeted issues**: discussion on project plan for issues raised in the comment letters that were outside the five targeted areas.

1 May 2014

**Topics discussed at the 25 April 2014 IASB meeting – continuation**

The decisions reached during the 25th of April 2014 meeting apply only to non-participating contracts until the IASB has completed its redeliberations on participating contracts and revisited prior decisions against the final accounting model for participating contracts.

The following summarises the Board's tentative decisions taken in redeliberating the proposals in the 2013 ED:

### Presenting insurance contract revenue and expenses

Insurance contract revenue is calculated as the sum of the change in the risk adjustment for cash flows associated with future coverage, the release of the CSM and the amount for expected claims and benefits for the period. It reflects the insurer's progress in satisfying the obligation to provide insurance coverage and other services and is recognised over the coverage period.

Investment components that are not considered as distinct and therefore not unbundled from the insurance contract are disaggregated and excluded from the amounts of insurance revenue and expenses.

Actual claims, benefits and expenses incurred in the period and after disaggregation of non-distinct deposit components are presented in the insurance expenses line.

The Board tentatively decided to prohibit an entity from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue.

The Board also tentatively decided to require entities to present insurance contract revenue in the statement of comprehensive income as proposed in the 2013 ED.

The Board tentatively confirmed its proposals relating to disclosures required relating to volume information. These are:

- a reconciliation that separately reconciles the opening and closing balance of the components of the insurance contract asset or liability;
- a reconciliation from premiums received in the period to the insurance contract revenue in the period;
- the inputs used when determining the insurance contract revenue that is recognised in the period; and
- 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.

### Project plan for non-targeted issues

The Board tentatively decided to consider the following non-targeted issues raised in the comment letters in future meetings:

- fixed fee service contracts;
- significant insurance risk guidance;
- portfolio definition and unit of account;
- discount rate for long term contracts and unobservable market data;
- asymmetrical treatment of reinsurance contracts;
- recognition of contracts acquired through portfolio transfer or business combination; and
- allocation pattern for the contractual service margin.

The Board tentatively decided not to consider other non-targeted issues raised in the comment letters, apart from those listed above.

## Tentative decisions from 18 March IASB meeting

### Unlocking the CSM

The Board tentatively confirmed its proposal in the 2013 ED that after inception, the CSM should be adjusted for the differences between the current and previous estimates of the present value of cash flows relating to future coverage and/or future services, subject to the condition that the CSM should not be negative.

The Board also tentatively confirmed its proposal in the 2013 ED that differences between the current and previous estimates of the present value of cash flows that do not relate to future coverage and other future services (e.g. development of incurred claims) should be recognised immediately in profit or loss.

*Treatment of previously recognised losses*

The Board tentatively decided that favourable changes in the estimates of the present value of future cash flows that arise after losses were previously recognised in profit or loss because a portfolio of insurance contracts had been deemed onerous (i.e. the probability weighted present value of cash outflows plus risk adjustment exceed that of cash inflows) should be recognised in profit or loss to the extent that they reverse losses related to coverage and other services in the future. Any excess of favourable changes in cash flow estimates over losses previously recognised in profit or loss would rebuild the CSM component of the insurance portfolio liability.

*Unlocking of CSM for changes in the risk adjustment*
The Board tentatively decided that differences in the current and previous estimates of the risk adjustment that relate to coverage and other services for future periods should adjust the CSM subject to the condition that the CSM should not be negative. Consequently, changes in the risk adjustment that relate to the coverage and other services provided in the current and past periods should be recognised in profit or loss.

### Use of OCI to present the effect of changes in discount rates

The Board tentatively decided to provide an option for insurers to present the effect of changes in discount rates in profit or loss or in OCI as an accounting policy choice at the portfolio level.

The IASB Staff has been requested to develop guidance to ensure that insurers apply consistently the same accounting policy to groups of similar portfolios and also to develop guidance on when insurers could make subsequent changes to the accounting policies based on IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The Board tentatively decided that if the insurer chooses to present the effect of changes in discount rates in OCI, the insurer should recognise:

- in profit or loss, the interest expense determined using the discount rates applied at the initial recognition of the contract (“locked-in discount rates”); and
- in other comprehensive income, the difference between the carrying amount of the insurance contract measured using the discount rates applied at the reporting date and the carrying amount of the insurance contract measured using the locked-in discount rates.

These decisions were tentatively reached for insurance contracts other than those where “the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends wholly or partly on the returns on underlying items”. These contracts are often referred to as participating contracts.

The Board will revisit this decision when the redeliberations on participating contracts are completed in its future meetings.

*Disclosures – OCI Solution*
The Board tentatively decided that additional disclosures are considered necessary for users to understand how interest expense and changes in discount rates are recognised.

The additional disclosures will require insurers to disclose an analysis of total interest expenses included in total comprehensive income disaggregated into:

- the amount of interest accretion determined with current discount rates;
- the effect on insurance liabilities of discount rate changes in the period; and
- the difference between the present value of changes in expected cash flows that adjust the CSM in the reporting period, measured using locked-in discount rates and current discount rates.

The Board also tentatively decided to require insurers to make additional disclosures for portfolios of insurance contracts for which the effect of changes in discount rates are presented in OCI. An analysis of the total interest expenses included in total comprehensive income disaggregated at a minimum into:

- interest accretion at the locked-in discount rate reported in profit or loss for the period; and
- the movement in OCI for the period.

## Summary of the 2013 ED

### Definition and scope

An insurance contract is defined as ‘a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder’.

The entity will apply the standard to its issued insurance contracts, the reinsurance contracts that it holds and the investment contracts with discretionary participating features that it issues provided the entity also issues insurance contracts.

The following contracts have been scoped out of the 2013 ED:

- product warranties issued directly by a manufacturer, dealer or retailer;
- employers’ assets and liabilities under employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans;
- contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item;

- residual value guarantees embedded in a lease provided by lessee or lessor, or provided by a manufacturer, dealer or retailer;

- fixed-fee service contracts meeting specified conditions;

- financial guarantee contracts that are not explicitly regarded as insurance contracts by the insurer;

- contingent consideration payable or receivable in a business combination; and

- insurance contracts in which the entity is a policyholder, unless those are reinsurance contracts.

### Unbundling

For recognition and measurement, a component of an insurance contract should be unbundled if it functions independently from other components of that contract. A component functions independently if it is not significantly interdependent with other components of the insurance contract. An insurer shall unbundle the following components of a contract that are not closely related to the insurance coverage specified in that contract:

- investment component – if a contract with equivalent terms is sold, or could be sold, separately in the same market or jurisdiction, either by insurers or other entities;

- embedded derivatives that are separated under existing bifurcation guidance; and

- performance obligations to provide goods or services where the insurer or another entity regularly sells the good or service separately in the same market or jurisdiction or where the policyholder can benefit from the goods or services either on its own or together with other resources that are readily available to the policyholder.

### Recognition

The insurer would recognise an insurance contract on the earlier of the following:

(a) the beginning of the coverage period;

(b) the date on which the first payment from the policyholder becomes due; and

(c) the date on which the portfolio of insurance contracts to which the contract will belong is onerous.

### Measurement

The insurer would measure an insurance contract under the building block approach ("BBA") where the insurance liability is reported with explicit components all based on current estimates. The building blocks that comprise the BBA include:

- the unbiased, probability-weighted estimate of cash flows which is discounted for the time value of money;

- a risk adjustment that measures the effects of uncertainty about the amount and timing of future cash flows; and

- a CSM which represents the unearned profit in a contract and is released through income as the insurer fulfils its performance obligations under the contract.

For pre-claims liabilities of insurance contracts with coverage shorter than 12 months or that pass certain tests on limited cash flow variability if coverage is in excess of 12 months, the insurer is permitted to use the premium allocation approach ("PAA") as a proxy to the BBA, provided that using PAA will result in a reasonable approximation to the BBA.

### Estimation of cash flows

The measurement of a portfolio of insurance contracts should include current, unbiased probability weighted present value of all cash flows that relate directly to the fulfilment of the portfolio of contracts. The estimates of the cash flows should be explicit from the discount and risk adjustments. This amount is based on the insurer's own estimates of cash flows and probabilities, provided that the estimates of any relevant market variables do not contradict the observable market prices (e.g. the market prices of assets used to determine cash flows of asset-linked insurance benefits). Additionally, the estimates must reflect all available information and relate to all the cash flows within the contract boundary of each contract in the portfolio.

An insurer should include, among the costs necessary to fulfil the contract, all costs directly associated with it (direct costs) and a systematic allocation of cost that relate to the contract or contract activities (indirect costs).

### Discount rate

The discount rate should reflect the characteristics of the cash flows of the insurance contract liability, e.g. timing, currency and liquidity and should exclude factors that are not relevant to the insurance contract liability, e.g. insurer's own credit risk.

#### Approaches to calculating the discount rate

Two approaches in calculating the discount rate were provided in the application guidance to the 2013 ED.

These are:

(a) Top-down approach – An appropriate yield curve is determined based on current market information and can reflect the actual assets that the insurer holds or be based on a reference asset portfolio adjusted for any effects or factors influencing the observable market prices but not relevant to the cash flows of the insurance contract. These for example include: (i) duration mismatches between the cash flows in the reference asset portfolio and those of the liability, (ii) market risk premiums, and (iii) credit risk.

(b) Bottom-up approach – The discount rate is determined as the risk-free yield curve adjusted for the liquidity characteristics of the insurance contract.

### Contractual service margin

At initial recognition, the CSM is calculated as an amount equal and opposite to the sum of the amount of fulfilment cash flows and any pre-coverage cash flows.

Subsequently, the CSM is recognised through profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the contract and it is adjusted for the differences between the current and previous estimates of the present value of cash flows relating to future coverage and/or future services, subject to the condition that the CSM should not be negative.

### Acquisition costs

Directly attributable acquisition costs form part of the insurance contract cash outflows, with the attribution done at the portfolio level, rather than at individual contract level.

### Measuring and presenting cash flows from contracts with a contractual link to underlying items

For contracts with a contractual link to underlying items, e.g. participating contracts, the insurer is required to decompose the cash flows within the contract and apply the accounting treatment specified in the 2013 ED depending on the cash flow behaviour.

Where the contractual cash flows vary directly with the underlying items, these cash flows will be measured and presented with reference to the asset's carrying amount.

Where the contractual cash flows vary indirectly with the underlying items, the cash flows are measured under the general BBA, discounted at a current discount rate. Any interest-related changes are always recognised in the profit or loss. Changes of future cash flows associated with this component of contractual cash flows will not unlock the CSM and will also be always recognised in the profit or loss.

Where the contractual cash flows do not vary with the underlying items, the cash flows are measured under the general BBA including the unlocking of the CSM.

### Asset dependent cash flows in non-participating contracts

For insurance contracts where the cash flows are expected to vary directly with returns on the underlying items but for which the insurer is not contractually required to hold the underlying item, the insurer is not required to decompose the contractual cash flows. Instead, the insurer is required to account for the entire contract under the BBA. The discount rate used should reflect the dependence of the cash flows on the returns of the underlying items.

An insurer is required to reset the discount rate if based on its revised expectations it expects that changes in the returns of the underlying items would affect the amount of the cash flows from the contract. Any difference between the reset rates and the current discount rates used to measure the liability in the statement of financial position would be accounted for through OCI.

### Reinsurance contracts held

The point of recognition for reinsurance contracts held is from the beginning of the coverage period, if the reinsurance contract provides coverage for the aggregate losses of a portfolio of underlying contracts; and when the underlying contracts are recognised in all other cases.

Reinsurance contracts held are measured using the BBA. Similar to insurance contracts, the PAA may be applied only during the coverage period where it is a reasonable approximation of the BBA.

In determining the fulfilment cash flows for reinsurance contracts, the assumptions used are consistent with those used for underlying insurance contracts and will need to reflect the risk of non-performance by the issuer.

The risk adjustment reflects the risk being transferred by the holder of the reinsurance contract (the cedant) thus requiring it to be measured with reference to the reinsured insurance contracts' risk adjustment.

The CSM is calibrated against the reinsurance premiums due to the reinsurer, resulting in no day 1 gain for the cedant at initial recognition of the reinsurance contract. This CSM reduces the reinsurance asset and it is recognised as income based on the cedant's receipt of the reinsurance coverage purchased.

In addition, only for prospective reinsurance (i.e. reinsurance purchased for unexpired insurance contracts coverage) the cedant will not recognise a day 1 loss if the reinsurance premiums due are higher than the expected recoveries. It would instead amortise this CSM component of the reinsurance asset over the reinsurance coverage period. In all other cases the difference will be recognised as a day 1 loss on purchase of a reinsurance contract.

### Modification and derecognition

The following modifications in an insurance contract are considered substantial and will result in the derecognition of the existing contract and the recognition of a new contract based on the modified terms, either under the future IFRS on insurance contracts or other applicable standards:

(a) if the modified contract would be out of scope of the IFRS for insurance contracts;

(b) if the modified contract would have been included in a different portfolio if written at inception; and

(c) if the modified contract is no longer eligible for applying the PAA.

For modifications that will result in additional benefits, a new contract will be recognised for the additional benefits only, with the CSM being determined by reference to the additional premium received.

If the modification will result in the reduction of benefits, that portion of the contract related to the reduction of benefits is derecognised.

Any changes in the cash flows that do not affect the level of benefits will be accounted for as a change in cash flow estimates.

### Presentation

#### Statement of financial position

The insurer is required to present separately portfolios of insurance contracts that are in an asset position from portfolios of insurance contracts that are in a liability position. Similarly, the insurer is required to present reinsurance contract assets separately from reinsurance contract liabilities.

#### Statement of comprehensive income

The components of comprehensive income are specified in the 2013 ED.

The insurer is not allowed to offset (a) income or expense from reinsurance contracts against the expense or income from insurance contract; and (b) present income and expense from underlying items against income and expense from the insurance contract.

### Disclosures

Key disclosures required include explanation of amounts recognised in the financial statements, significant judgement used and the nature and extent of risks arising from insurance contracts.

Disclosures relating to amounts recognised include the expected present value of future cash flows, changes in risk during the period, changes in CSM and the effects of new contracts written in the period.

Insurers are required to disclose information about significant judgements used. In particular the entity would be required to disclose the processes used for estimating inputs and the methods used, the effect of changes in the methods and inputs used and an explanation of the reason for the changes, identifying types of contracts affected.

Disclosures about risk include the nature and extent of risks arising from insurance contracts, the extent of mitigation of risks arising from reinsurance and participation features and the quantitative information about exposure to credit, market and liquidity risk.

### Approach to transition

Insurers are required to apply the standard retrospectively and to maximise the use of objective data.

The 2013 ED provides practical expedients to insurers where retrospective application is deemed impracticable. These are:

#### Expected cash flows at initial recognition

In determining expected cash flows at initial recognition, the insurer assumes that all subsequent changes in cash flows were known in advance at the date of initial recognition and restate prior periods with the benefit of hindsight.

#### Discount rate at inception

Determining the locked-in discount rates retrospectively depends on whether there is a an observable yield curve that approximates the yield curve that would have been applied in accordance with the standard for at least three years before the date of transition. If there is such rate insurers would be required to use that observable yield curve. Where there is no market-observable yield curve, the discount rates can be determined using the closest market-observable yield curve. The same market-observable reference point must be used to determine the locked-in discount yield curve for each of the years in the retrospective period. The yield curve determined above is used for recognising interest expense on the accretion of the discount rates. The cumulative effect of the difference between those yield curves and the discount rate yield curve determined at the transition date is recognised in the accumulated OCI for all those portfolios for which the insurer has elected the use of the OCI solution.

#### Risk adjustment

The insurer can assume that the risk adjustment determined at initial recognition is the same as the risk adjustment determined on the date of transition.

#### Contractual service margin

For contracts with remaining coverage at transition date, insurers would need to determine the portion of CSM that relate to future coverage and/or service, with the difference recognised in retained earnings.

## Thinking ahead

- Insurers should start building a plan for the data gathering process in view of the retrospective application of the insurance contract standard and the new data inputs required under the accounting model.
- Insurers should evaluate whether their current actuarial and accounting systems are flexible enough to be enhanced to address the new data and measurement requirements of the insurance contract standard.
- Another aspect that insurers should consider is whether it has enough staff resources to manage both the transition process and maintain 'business as usual' operations.
- Various stakeholders, such as policyholders, analysts, investors, regulators and provider of credit would need to be educated on the implications of the new standard.

## Next steps

The Board will meet next on 19 to 23 May 2014. At the time of publication, no indication was made with regards the specific topics to be discussed on this meeting in relation to insurance contracts. Of the five targeted areas that were opened for comments, only two targeted areas remain to be redeliberated by the Board: (a) accounting for participating contracts; and (b) the transition requirements. As indicated during the April IASB meeting, the Board will address the non-targeted areas that they have been tentatively decided to address at future IASB meetings.

Once issues relating to participating contracts have been addressed, the IASB Staff will consider whether the tentative decisions reached for non-participating contracts will need to be revisited.



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