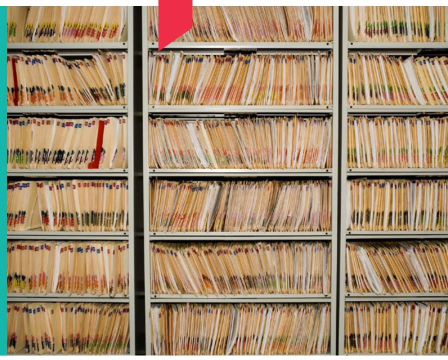
INSURANCE CONTRACTS
INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/19



Summary

The International Accounting Standards Board (IASB) has issued Exposure Draft 2013/7 *Insurance Contracts* (the ED) for public comment, which sets out proposed changes to the accounting for insurance contracts. The ED has been developed through a joint project with the US Financial Accounting Standards Board (FASB).

This latest ED supersedes and builds upon the previous ED released by the IASB in 2010 relating to insurance contracts (ED/2010/8).

Like the 2010 ED, the revised ED would apply to **any entity** that:

– Issues insurance or reinsurance contracts
– Holds reinsurance contracts
– Issues an investment contract with a discretionary participation feature.

Therefore the scope of the proposals is not limited to only those entities that are regulated insurance companies.

While the basic mechanics and logic of the proposed accounting for insurance contracts has remained largely intact from the 2010 ED, there are a number of key changes in the revised ED on which the IASB is seeking specific comment from constituents, including:

1) Measurement: Adjusting the contractual service margin
2) Measurement: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items
3) Presentation: Insurance contract revenue and expenses
4) Presentation: Interest expense in profit or loss
5) Effective date and transition.

The ED has been published with a 120 day consultation period, with comments due by 25 October 2013.

STATUS
Exposure Draft

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
Significant changes proposed to the accounting requirements for **any** entity that issues insurance or reinsurance contracts, holds reinsurance contracts, or issues an investment contract with a discretionary participation feature.

Background

When the previous International Accounting Standards Committee (IASC) was superseded by the International Accounting Standards Board (IASB) in 2001, there was no specific standard in the then current suite of International Accounting Standards (IAS's) addressing the accounting for insurance contracts.

Accordingly, in September 2001, the insurance contracts project was added to the IASB's agenda.

In the knowledge that a number of major jurisdictions were adopting IFRS in 2005, the IASB issued IFRS 4 *Insurance Contracts* in March 2004 as an interim 'stop-gap' measure that enabled existing practices relating to the accounting for insurance contracts to continue. It was intended that IFRS 4 would be followed by a more comprehensive and fundamental reassessment of the accounting treatment of insurance contracts.

Because existing (previous GAAP) accounting practice was allowed to continue for the purposes of reporting in accordance with IFRS, IFRS 4 fails to require the provision of sufficient relevant information to users of financial statements in order to enable them to make meaningful comparisons between entities that have issued insurance contracts. This is only partially addressed by extensive disclosure requirements.

In September 2004 the IASB established an *Insurance Working Group* to analyse accounting issues relating to insurance contracts. This group incorporates a wide range of interested parties, including senior financial executives involved in financial reporting by insurance companies.

Subsequently, the IASB issued a discussion paper in May 2007, followed by its first exposure draft (ED/2010/8) in July 2010. The objective of this initial ED (developed jointly with the US Financial Accounting Standards Board) was to a develop a single, high-quality standard that would address the recognition, measurement, presentation and disclosure requirements related to insurance contracts.

The measurement model proposed in the initial ED was based on the premise that the issuer of an insurance contract (generally) fulfils its obligations under that contract by paying benefits and claims to the policyholder over time, as opposed to transferring those liabilities to another party.

The proposed measurement model incorporated cash inflows from premiums and cash outflows from benefits, claims, and costs to establish the 'building blocks' of the proposed measurement model, including:

– A current estimate of future cash inflows and outflows
– A discount rate (to reflect the value of the money)
– An explicit risk adjustment (to reflect the maximum amount the entity would pay to be relieved of the risk in relation to where the ultimate fulfilment cash flows exceeded the expected cash flows)
– A residual margin (now termed the 'contract services margin').

In addition, the initial ED required that any incremental acquisition costs (on an individual contract basis) for contracts actually issued were to be included as part of the contract's cash flows.

The IASB received more than 400 comment letters in response to the discussion paper and the initial ED, and subsequently conducted extensive outreach through the *Insurance Working Group*, various round table meetings and fieldwork initiatives.

While feedback to the initial ED was positive in respect of the objective and the measurement model proposed, concerns were raised in respect to:

– Representation
– Practical accommodations to conceptual approaches
– Clarification and guidance.

While the revised ED retains the base principles and logic of the initial ED, the IASB has made a number of significant changes in respect of:

– Measurement
– Presentation
– Transition.

The IASB is only seeking specific feedback in respect to these significant changes in the revised ED.

Summary of the proposals

Definitions

An *insurance contract* is defined 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.

Insurance risk is risk (other than financial risk) that is transferred from the holder of a contract to the issuer.

Scope (inclusions and exclusions)

The proposals apply to **all** entities that:

- Issue an insurance contract (including a reinsurance contract)
- Hold a reinsurance contract
- Issue an investment contract with a discretionary participation feature (provided that the entity also issues insurance contracts).

Specifically **excluded** from the scope of the ED are:

- Product warranties that are issued by a manufacturer, dealer, or retailer
- Employers' assets and liabilities that arise from employee benefit plans
- Contractual rights or contractual obligations that are contingent on the future use of, or the right to use, a non-financial item (e.g. some licence fees, royalties, contingent lease payments and similar items)
- Residual value guarantees that are provided by a manufacturer, dealer or retailer, and a lessee's residual value guarantee that is embedded in a finance lease
- Financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts
- Contingent consideration that is payable or receivable in a business combination
- Insurance contracts in which the entity is the policyholder (unless those contracts are reinsurance contracts)
- *Fixed-fee service contracts* that have, as their primary purpose, the provision of services and that meet all of the following conditions:
    i. The entity does not reflect an assessment of the risk that is associated with an individual customer in setting the price of the contract with that customer
    ii. The contract compensates customers by providing a service, rather than by making cash payments
    iii. The insurance risk that is transferred by the contract arises primarily from the customer's use of services.

BDO Comment

A common example of a *fixed-fee service contract* would be certain roadside assistance programs, whereby in the event of a 'claim' the entity is required to provide a service (i.e. repairing and/or removing the vehicle from the road) rather than providing monetary compensation to the customer.

Combining and separating insurance contracts

The ED proposes similar criteria to that proposed in ED/2011/6 *Revenue from Contracts with Customers*, regarding:

- The combination of multiple insurance contracts into a single insurance contract when they are entered into at or near the same time, with the same policyholder
- The separation of components within an insurance contract (e.g. investment component, service component etc.) that are then accounted for in accordance with other applicable IFRSs.

Recognition

An insurance contract is recognised at the earlier of:

- The beginning of the coverage period
- The contractual due date of the first payment (if not specified, the due date is deemed to be when the first payment is received)
- The date on which the portfolio of insurance contracts to which the contract will belong is onerous.

Any cash flows that occur prior to the coverage period under the insurance contract are recognised as they occur within the portfolio that will contain the insurance contract.

Initial measurement

An insurance contract is recognised at the earlier of:

(i) The amount of what are termed the fulfilment cash flows. This is the present value of future cash outflows and cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment

(ii) Any contractual service margin. This is the component of the insurance contract that represents the unearned profit that will be recognised as the entity provides services under the insurance contract.

(i) Future cash flows

The future cash inflows and outflows estimated must relate directly to the fulfilment of the portfolio of contracts. These estimates must:

- Be explicit
- Reflect the perspective of the entity (to the extent that they do not contradict the observable market prices)
- Incorporate all of the available information about the amount, timing and uncertainty of all of the cash inflows and outflows
- Be current (as at measurement date)
- Include the cash flows within the boundary of each contract in the portfolio.

Time value of money

The estimated future cash flows must be adjusted (i.e. discounted) to reflect the time value of money. The discount rate used must reflect the characteristics of the estimated future cash flows, and must:

- Be consistent with observable current market prices of instruments with similar characteristics
- Exclude the effect of any factors that influence the observable current market prices, but are not relevant to the cash flows of the insurance contract.

Risk adjustment

A risk adjustment relating to the uncertainty of the expected present value of cash flows must be incorporated in determining the initial measurement of the insurance contract.

(ii) Contractual service margin

Unless the insurance contract is onerous, the contractual service margin is determined as the amount that is equal and opposite to the sum of:

(i) The amount of the fulfilment cash flows for the insurance contract at initial recognition

(ii) Any pre-coverage cash flows.

Note: The ED contains significant application guidance in respect of the various elements above when determining initial measurement.

Subsequent measurement

The carrying amount of an insurance contract as at reporting date is equal to the sum of:

(i) The fulfilment cash flows at that date

(ii) The remaining amount of the contractual service margin at that date.

Note: The ED contains significant application guidance in respect of these elements when determining subsequent measurement.

Simplified approach (premium-allocation approach)

There is an exception in respect to the initial and subsequent measurement requirements outlined above in respect of insurance contract liabilities.

An entity may apply the simplified approach (i.e. the 'premium-allocation approach'), if:

- The simplified approach provides a reasonable approximation of the measurement that would be obtained through application of the detailed requirements
- The coverage period at initial recognition is one year or less.

(i) Initial measurement (simplified approach)

The initial carrying amount of the liability for the remaining coverage is equal to:

- The premium received at initial recognition, less
- Any payments that relate to acquisition costs, plus (or minus)
- Any pre-coverage cash flows, plus
- Any onerous contract liability recognised.

(ii) Subsequent measurement (simplified approach)

The carrying amount of the liability for the remaining coverage at each reporting date is equal to:

- The previous carrying amount, plus
- The premiums received in the period, minus
- The amount recognised as insurance contract revenue for coverage that was provided in that period, plus
- Any onerous contract liability recognised in the period, plus (or minus)
- The effect of any changes in estimates that relate to any onerous contract liability recognised in previous periods, plus
- Any adjustment to reflect the time value of money.

Derecognition

An insurance contract (or part of it) is derecognised only when it is extinguished (i.e. when the entity is no longer exposed to any risk to transfer any economic benefits to the policyholder).

Typically, this occurs when the obligation under the insurance contract has been discharged, cancelled, or has expired.

In situations relating to the purchase of reinsurance, the underlying insurance contract(s) are only derecognised if the underlying insurance contract(s) are extinguished.

Modifications

When the parties to an insurance contract agree to a change of terms, an entity must (subject to meeting specific criteria in the ED):

- Derecognise the original insurance contract
- Recognise the modified contract in accordance with the applicable relevant IFRS.

Any gains or losses that arise on modification of a reinsurance contract are recognised as an adjustment to the cash outflows arising from the contract.

Any gains or losses that arise on modification of all other insurance contracts are measured as the difference between:

- The deemed consideration for the modified contract
- The carrying amount of the derecognised contract.

Presentation

(i) Statement of Financial Position

Separate line items would be included in the statement of financial position for:

- Insurance contracts in an asset position
- Insurance contracts in a liability position
- Reinsurance contracts in an asset position
- Reinsurance contracts in a liability position.

(ii) Statement of comprehensive income

Items presented in *profit or loss* would include:

- Revenue from insurance contracts
- Incurred claims and *other expenses*[1]
- Investment income components (from components that have not been separated).

[1] *Other expenses* recognised in *profit or loss* would include:

- Losses at initial recognition
- Changes in the risk adjustment
- The change in the contractual service margin that reflects the transfer of services in the period
- Changes in estimates of future cash flows that do not adjust the contractual service margin
- Differences between actual cash flows that occurred during the period and previous estimates of those cash flows
- Any changes in the carrying amount of onerous contracts
- Any effect of changes in the credit standing of the issuer of reinsurance contracts held
- Interest expense on insurance contract liabilities
- Any gains or losses other than those required to be recognised in other comprehensive income.

Items presented in *other comprehensive income* include:

- The effect of discount rate changes on the insurance liability.

An entity is prohibited from offsetting:

- Income or expense from reinsurance contracts against the expense or income from insurance contracts
- Income or expense from the underlying items against expense or income from the insurance contract.

Statement of Comprehensive Income	
	20XX
Insurance contracts revenue	x
Incurred claims and other expenses	(x)
Operating result	**x**
Investment income	x
Interest expense on insurance liability	(x)
Investment result	**x**
Profit or loss	**x**
Fair value changes of assets	x
Effect of discount rate changes	(x)
Total comprehensive income	**xx**

Figure 1 – Illustrative presentation (simplified) of the statement of comprehensive income under the proposals

Disclosures

An entity would be required to present disclosures that enable the users of financial statements to understand the nature, amount, timing and uncertainty of future cash flows that arise from insurance contracts, including (at a high-level) disclosures regarding:

- The amounts recognised in the entity's financial statements that arise from insurance contracts
- The significant judgements, and changes in those judgements made
- The nature and extent of the risks that arise from insurance contracts.

The proposed disclosure requirements are set out in paragraphs 69 – 95 of the ED.

Summary of key changes from the 2010 ED on which the IASB is seeking comments

There are five key changes from the 2010 ED on which the IASB is seeking comment, being:

1) Measurement: Adjusting the contractual service margin
2) Measurement: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items
3) Presentation: Insurance contract revenue and expenses
4) Presentation: Interest expense in profit or loss
5) Effective date and transition.

1) Measurement: Adjusting the contractual service margin

This relates to adjustments for changes in cash flows relating to future insurance coverage.

2010 ED	Revised 2013 ED
The effect of a change in estimate is recognised in full in the period in which the entity changes its estimate. Subsequently, the contractual service margin continues to be recognised as was expected on initial recognition.	The effect of a change in estimate is recognised over the remaining coverage period.

Figure 2 – Difference between 2010 ED and Revised 2013 ED regarding adjusting the contractual service margin

The effect of this revision is that:

– There is reduction in the period-on-period volatility to profit or loss
– How changes in measurements are presented.

2) Measurement: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

The 2013 ED proposes that, when there can be no economic mismatch between the insurance contract and assets backing that contract, there are exceptions allowed in respect of:

– How the insurance contract is measured
– How changes in measurements are presented.

The exception applies when the insurance contract requires that an entity holds the underlying items and specifies a link to returns on those underlying items. As a result, the exception ensures that the measurement of the insurance contract is consistent with that of the underlying item.

For cash flows that vary directly with underlying items, the mismatch is eliminated by measuring and presenting the insurance contract consistently with the measurement and presentation of the underlying items.

All other cash flows are measured using general requirements of the ED. However, all changes in value of these cash flows are presented in profit or loss.

3) Presentation: Insurance contract revenue and expenses

2010 ED	Revised 2013 ED
Present only net margin information in the statement of comprehensive income.	Present insurance contract revenue on a consistent basis to revenue presented under other IFRSs (i.e. in accordance with the *Revenue from Contracts with Customers* ED).

Figure 3 – Difference between 2010 ED and Revised 2013 ED regarding the presentation: Insurance contract revenue and expenses

The 2013 ED proposes that in determining operating profit an entity would present separate line items for:

(i) Insurance contract revenue, which incorporates values relating to:
– Changes in the contractual service margin
– Changes in risk
– Claims/expenses expected.

(ii) Claims/expenses incurred.

4) Presentation: Interest expense in profit or loss

The 2013 ED proposes that interest expense from insurance contracts is presented in such a way so that:

– In profit or loss it reflects a *cost-based measurement*
– In the statement of financial position the carrying amounts reflect a *current-value-based measurement*.

The effect of this proposal is that:

– It would highlight underwriting performance in the statement for comprehensive income
– It would align the insurance contract proposals with the proposals of ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*, which introduces a fair value through OCI (FVOCI) category for some simple debt instruments.

5) Effective date and transition

2010 ED	Revised 2013 ED
An entity should assume that there would be no unearned future profit when the entity first applies the proposals.	An entity is required to estimate the remaining unearned profit and insurance contract revenue on their existing insurance contracts.

Figure 4 – Difference between 2010 ED and Revised 2013 ED regarding effective date and transition

While the proposals in the original 2010 ED were simpler to apply, the effect upon insurance contracts in existence at transition date would have been:

– Lower carrying amounts recognised in the statement of financial position
– No recognition of profits over the remaining coverage period.

Therefore the effect of this revision would be an improvement to comparability between insurance contracts entered into before and after transition to the new proposals.

Convergence with US GAAP

The new insurance contact proposals have been developed from a joint project between the IASB and US FASB, undertaken in the interest of developing improved and simplified financial reporting requirements for the accounting of insurance contracts.

Accordingly, most (but not all) of the conclusions reached by the IASB and FASB are consistent in each proposal. However, there are differences in respect of:

- The pattern of profit recognition
- How an entity reflects changes in the estimates of the profit earned from insurance contracts.

Because up until now the FASB has not released any exposure drafts in relation to the insurance contracts project, the FASB is seeking comments and input on the entire package of its recently released proposals. The IASB on the other hand is only seeking comments and input in relation to the key changes between its 2010 and 2013 EDs.

Both proposals have overlapping comment periods which will allow constituents the opportunity to review and comment on both proposals.

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