Deloitte.

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.

Alternative accounting model for participating contracts proposed by the European CFO Forum

During the 19 November 2014 meeting, representatives of the European CFO Forum presented in an educational session the alternative proposal to account for contracts with participating features ("participating contracts").

The alternative accounting model for participating contracts was developed by the European CFO Forum in response to the concerns insurers have on the 2013 ED proposals on the accounting for participating contracts. These proposals in the 2013 ED were known as the 'mirroring' approach. The proposed alternative accounting model builds on the IASB's framework of current fulfilment value measurement for insurance liabilities and it is intended to be in line with the general building block model as proposed by the IASB. Consequently, the European CFO Forum argues that there will be a single measurement basis for all insurance contracts. Refer to 'Proposed alternative model by European CFO Forum: accounting for participating contracts' section for details of the proposals.

23 January 2015

Tentative decisions in redeliberating the 2013 ED

Topics discussed at the 22 January 2015 IASB meeting
During the meeting, the Board tentatively confirmed the transition reliefs provided in the 2013 ED that permit an insurer to redesignate, under specified circumstances, its financial assets upon initial application of the Insurance Contracts standard and require revoking a previous designation if the new Standard on insurance contracts eliminates the accounting mismatch that led to that designation.

The Board also tentatively decided to consider providing additional transition relief to permit or require an insurer to reassess the business model for financial assets at the date of the initial application of the new insurance contracts Standard.

The following summarises the Board's tentative decisions taken in redeliberating the proposals in the 2013 ED. The tentative decisions reached to-date apply only to non-participating contracts. The Staff plans to ask the Board for decisions on participating contracts as a whole at a future meeting. Once the Board has completed its redeliberations on participating contracts, the Board plans to revisit prior decisions against the final accounting model for participating contracts.

Tentative decisions from 22 January 2015 IASB meeting

Initial application of the new insurance contracts Standard after implementation of IFRS 9, *Financial Instruments*

The Board tentatively confirmed the 2013 ED proposals that allow insurers to redesignate their financial assets upon initial application of the new Insurance Contracts Standard under specified circumstances.

The Board also tentatively decided to consider providing additional transition relief to either permit or require an insurer to reassess its business model for financial assets at the date of initial application of the new Insurance Contracts Standard using facts and circumstances that exist at that date. The reassessment will effectively consider for a second time the existence of the conditions set out in paragraphs 4.1.2(a) and 4.1.2(A) of IFRS 9 which respectively lead to the classification of the asset at amortised cost or at fair value through other comprehensive income.

Extracts from the 2013 ED on *Redesignation of financial assets*

C11 *At the beginning of the earliest period presented, when an entity first applies this [draft] Standard, it is permitted, but not required:*

(a) to redesignate a financial asset as measured at fair value through profit or loss if that financial asset meets the condition in paragraph 4.1.5 of IFRS 9, as applicable, at the date when the entity first applies this [draft] Standard.

(b) if the entity has previously applied IFRS 9:

(i) to designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9; or

(ii) to revoke a previous designation of an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9.

C12 *An entity is required to revoke previous designations of financial assets as measured at fair value through profit or loss if the initial application of this [draft] Standard eliminates the accounting mismatch that led to that previous designation.*

As indicated in the Staff Paper, the following topics relating to the proposed additional transition relief as discussed in the preceding paragraph will be considered at a future meeting:

a) the financial assets for which the transition relief would apply;

b) when there is a change in the classification of the financial assets at transition date as a result of applying the transition relief:

   i. whether such a change should be applied prospectively or retrospectively;

   ii. how any resulting gains or losses should be treated; and

   iii. disclosures required if the business model for financial assets is changed upon initial application of the new Insurance Contract Standard.

The Board also tentatively decided not to defer the mandatory effective date of 1 January 2018 for IFRS 9 for entities issuing insurance contracts.

Tentative decisions from 23 October 2014 IASB meeting

Transition for contracts with no participating features

The Board tentatively confirmed the 2013 ED proposals that, at the beginning of the earliest period presented ("transition date"), an insurer should apply the proposed Insurance Contracts standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, unless impracticable.

Simplified approach

The Board has also tentatively confirmed the 2013 ED proposals on using a simplified approach to transition in instances where a retrospective application is deemed impracticable. The insurer will be required to apply all the proposed simplifications as detailed in paragraphs C5 and C6 of the 2013 ED, with a modification on the proposed method of determining the risk adjustment at transition date as discussed below. Refer to 'Summary of the 2013 ED *Approach to Transition*' section for details of the original 2013 ED proposals on transition requirements.

Where an insurer applies the simplified approach to transition, the Board tentatively decided that the insurer should estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the transition date by the expected release of the risk from initial recognition to transition date. The expected release of the risk should be determined by reference to similar insurance contracts that the insurer issues at the transition date.

Fair value approach

The Board tentatively agreed that, if the simplified approach is impracticable, the insurer should apply a "fair value approach". It should be noted that the fair value approach is not an alternative approach to the simplified approach but an approach to be applied only in circumstances where a simplified approach is deemed impracticable.

Under the fair value approach, the insurer shall determine the contractual service margin at the transition date as the difference between the fair value of the insurance contract and the fulfilment cash flows measured at that date.

The discount rate to be used for determining interest expense in profit or loss and the related amount of Other Comprehensive Income accumulated in equity will be determined by estimating the discount rate at the date of initial recognition of the insurance contract using the method in the simplified approach proposed in paragraph C6 (c) and (d) of the 2013 ED.

Disclosure requirements

The Board tentatively agreed that for each period presented for which there are contracts that were measured in accordance with the simplified approach or the fair value approach, an insurer should disclose separately the information proposed in paragraph C8 of the 2013 ED for contracts measured using the simplified approach and for contracts measured using the fair value approach.

Tentative decisions from 23 September 2014 IASB meeting

Book yield and effective yield approaches to present interest expense in profit or loss

During previous Board meetings, the Board directed the Staff to explore two approaches, the book yield approach and the effective yield approach, in determining the interest expenses presented in profit or loss. During this meeting, the Staff presented to the Board the different views in how the book yield and effective yield approaches would be applied and proposed how to define each approach. The Staff also provided illustrative examples using different scenarios to illustrate the consequences of each approach. It is to be noted that neither approaches will impact the measurement of the insurance contract liability on the statement of financial position.

No decisions were required from the Board on these topics.

Book yield approach

The objective of the book yield approach is to reduce accounting mismatches between the presentation of the interest expense in the profit or loss and interest income on the underlying items when there is an economic match between the underlying item and the insurance contract liability.

The four steps in applying a book yield approach are as follows:

(1) *Identifying the underlying items.* The book yield approach is applicable only where the insurer holds the underlying items and for which the policyholders receive a substantial proportion of the returns from these underlying items.

(2) *Determine the book yield for the underlying items.* The book yield is derived from the accounting returns of the underlying items which may be determined on a cost, amortised cost or fair value basis depending on the accounting treatment of the underlying returns.

The Board considered and discussed their views on the Staff's analysis on the determination of the book yield for common types of underlying items.

(3) *Construct a yield curve.* A five-step approach was presented by the Staff for constructing a yield curve.

(4) *Adjust the yield curve to eliminate any differences arising on initial recognition of the insurance contract.* An example of this adjustment is adjusting the yield curve to reflect the following:

- premiums received from new policyholders is used to settle claims of existing policyholders; and
- new policyholders 'inherit' the underlying items previously held to back the liability of pre-existing policyholders.

The Staff noted that in these cases the book yield will reflect the market interest rates from the purchase date of the underlying items rather than the initial recognition date of the new contracts.

Given the book yield will only operate for presentation purposes, the consequence of applying it as explained above is the recognition of an amount in OCI at initial recognition. The Staff proposed to always adjust the book yield at initial recognition such that there is no OCI amount being recognised in the financial statements on that date.

The Board discussed the Staff's proposed book yield approach that aims to minimise accounting mismatches and is applicable where:

a) the underlying items are bonds and the insurer reflect in the book yield the expected credit loss on the bonds accounted for at cost or fair value through other comprehensive income ('FVOCI');

b) the underlying items are investment properties measured at cost where the policyholders only benefit from a share in the rental income; and

c) when the underlying items, other than bonds and investment properties described in b) above, are accounted for at fair value through profit or loss ('FVTPL').

The Staff's version of the proposed book yield approach will not be permitted when the underlying items include equity instruments measured at fair value through OCI and investment properties measured at cost with the policyholder receiving a share of capital gains. The Staff argued that there would be accounting mismatches in these circumstances if the book yield approach is used.

Effective yield approach

The Staff presented for consideration to the Board two variations of the effective yield approach to present interest expense in profit or loss. These are the level yield method and the projected crediting method. The former is akin to that proposed previously by the FASB for its Insurance Contracts project. Under this method, an effective yield is determined on initial recognition as a single rate that exactly discounts estimates of future cash flows to the carrying amount of the insurance contract liability determined on an amortised cost basis at the reporting date and will be reset for changes in amounts expected to be paid to policyholders due to changes in the estimated investment returns.

The Staff recommends to the Board the second variation of the effective yield approach, the projected crediting method, as this method will result in the interest expense being more closely matched to the investment income than under the level yield method, thereby reducing accounting mismatches more effectively.

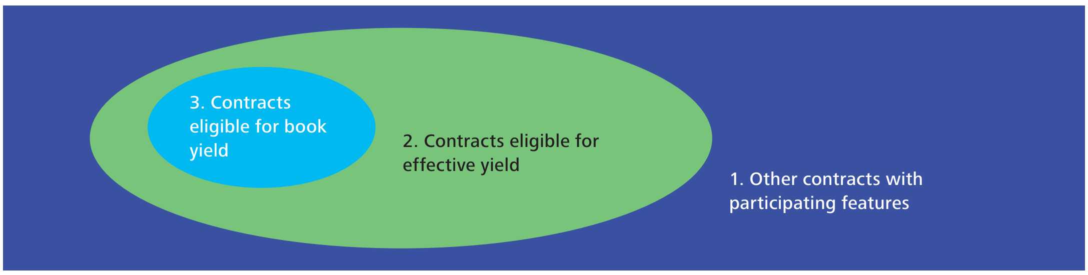
Under this method, the discount rates to be used should be the rates that an insurer intends to use to determine the policyholder cash flows that reflect amounts credited to policyholders as they share in the returns from underlying items.

Use of OCI for contracts with participating features

The Board also discussed whether, similar to what they decided for non-participating contracts, insurers should have an accounting policy choice at a portfolio level for presenting the effects of changes in discount rates either in profit or loss or OCI for participating contracts.

The diagram below illustrates that the book yield approach is applicable to a narrower set of participating contracts than those that will be eligible for effective yield approach. It is to be noted, however, that there would be other participating contracts not eligible for either book yield or effective yield approaches. These are contracts that fail the test of transferring to policyholders "substantially all of the return from the underlying items".

Applicability of book yield and effective yield approaches



Source: From IASB September 2014 Agenda Paper 2C

Sector 3: Participating contracts eligible for book yield approach

In its 17 June meeting, the Board tentatively decided to restrict the circumstances in which book yield approach to present interest expense to profit or loss can be applied to participating contracts (refer to *'Tentative decisions from 17 June IASB meeting'* section for further details). In addition, the Staff recommended to the Board to consider permitting the use of the book yield approach only when doing so will reduce accounting mismatches.

Where using book yield approach will result to or increase accounting mismatch between the insurance contract and the underlying items, the insurers will apply the effective yield method.

Should there be a book yield approach for determining interest expense in profit or loss

The Board also discussed their views over the Staff's proposal to further restrict the use of book yield approach to presenting interest expense in profit or loss by not permitting insurers to use the book yield approach where the insurer presents the effect of changes in discount rates in OCI for participating contracts.

Sector 2: Participating contracts eligible for effective yield approach

The Staff proposed that the effective yield approach to present interest expense to profit or loss is applicable to participating contracts where the cash flows that vary with the underlying items are a substantial proportion of the total benefits the policyholders will receive over the life of the contracts. However, unlike those participating contracts that are eligible for book yield approach, the insurer does not need to hold the underlying items.

Sector 1: Participating contracts not eligible for either book yield or effective yield approaches

For those contracts which do not meet the criteria for either the book yield approach or the effective yield approach, the insurer will apply the general model as applied to non-participating contracts for presenting interest expense to profit or loss which requires using discount rates locked-in at the inception of the insurance contract (refer to 'Tentative decisions from 18 March IASB meeting, *Use of OCI to present changes in discount rates'* section for further details).

Premium allocation approach: revenue recognition pattern

In its 21 May meeting, the Board tentatively decided to provide additional guidance on the allocation pattern for the contractual service margin ('CSM') using the building blocks approach ('BBA') for non-participating contracts (see section on *'Tentative decisions from 21 May IASB meeting'* section for further details). During this meeting, the Board discussed whether to provide similar guidance for PAA.

Under PAA, the insurance contract revenue for the period is measured as the amount of expected premium receipts allocated for the period.

The Board tentatively decided to clarify that, under PAA, an insurer should recognise insurance contract revenue in profit or loss on the basis of the passage of time and the expected number of contracts in force. There is a presumption that, under PAA (being a simplification of BBA) the release of risk is on a straight-line basis over the period of insurance coverage.

However, the Board also tentatively decided that, where the expected pattern of the release of risk significantly differs from that of passage of time, then the insurance contract revenue will be recognised in profit or loss on the basis of the expected timing of incurred claims and benefits.

This would be the case, for example, for a catastrophe insurance covering against losses arising from hurricanes. The risk of incurring a loss is greater during the hurricane season than outside the hurricane season and the difference in the risk would be captured in the revenue allocation using the expected timing of incurred claims as a proxy.

Determination of interest expense in the premium allocation approach

Under PAA, the liability for incurred claims is measured in the same way as that under BBA which requires insurers to discount the liability using a current discount rate curve.

In its 18 March meeting, the Board tentatively decided for non-participating contracts accounted for using BBA to provide insurers with an accounting policy choice at the portfolio level for presenting the effect of changes in discount rates either in profit or loss or OCI.

During this meeting, the Board tentatively decided that under PAA, when an insurer presents the effect of changes in discount rates in OCI, the discount rate that is used to determine the interest expense for the liability for incurred claims should be the rate locked-in at the date the claim was incurred. This requirement will also apply for the onerous liability recognised in the coverage period under PAA. In the case of an onerous portfolio of contracts, this will be the rate at the date the onerous liability is recognised.

Tentative decisions from 22 July 2014 IASB meeting

OCI mechanics for contracts with participating features

The Board discussed their views on the alternative approach to determining the presentation of interest expense when the issuer of participating contracts determines it would elect as its accounting policy to separate the effect of time value of money between profit or loss and OCI. The Board considered an approach similar to the effective interest rate method used for floating rate debt instruments under IFRS 9. The Board also considered whether to direct the Staff to explore the applicability of such approach to non-participating contracts.

The Board expressed their support for the Staff to explore an approach for determining interest expense (a) wherein the discount rate used for the presentation of interest expense in profit or loss should be reset for all the cash flows in the contract when the cash flows that vary with underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract; and (b) the approach being similar to the effective interest rate method. However, the Board expressed their views that the applicability of such approach to non-participating contracts be explored after the Board has decided on the approach for the participating contracts.

Rate used to accrete interest and calculate the present value of cash flows that unlock the CSM

The Board tentatively decided that locked-in rate at the inception of the contract should be used in accreting interest on CSM, and for calculating the change in the present value of expected cash flows that unlocks the CSM.

Changes in accounting policy

The Board's tentative decision during the 18 March meeting introduces an accounting policy choice at the portfolio level for presenting the effect of changes in discount rates. The policy would determine whether these changes would be presented entirely in the profit or loss or with a component in the profit or loss and another component in the other comprehensive income. The Board has tentatively decided during the 22 July meeting that insurers should apply IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, to changes in accounting policy relating to the presentation of the effect of changes in discount rates without providing further guidance to complement the IAS 8 requirements when they are applied to this particular accounting policy choice.

Tentative decisions from 17 June 2014 IASB meeting

Determining discount rates when there is lack of observable data

Paragraph B70 (a) of the 2013 ED provides that *"…in some cases, the entity determines that yield curve for the insurance contract based on a yield curve that reflects the current market rates of returns either for the actual portfolio of assets that the entity holds or for a reference portfolio of assets as a starting point. The rates of return for the portfolio include market risk premiums for credit risk and liquidity risk. In a 'top-down' approach, an entity:*

(i) excludes, from the observable rates of return that apply to a portfolio of assets, its estimates of the factors that are not relevant to the insurance contract. Such factors include market risk premiums for assets included in the portfolio that are being used as a starting point.

(ii) adjusts for differences between the timing of the cash flows of the assets in the portfolio and the timing of the cash flows of the insurance contract. This ensures that the duration of the assets is matched to the duration of the liability.

(iii) does not include, in accordance with paragraph 21, the risk of the entity's own non-performance.

While there may be remaining differences between the liquidity characteristics of the insurance contract and the liquidity characteristics of the portfolio, an entity applying the top-down approach need not make adjustments to eliminate those differences.

The Board tentatively confirmed the proposals in the 2013 ED for the discount rates used to adjust the cash flows in an insurance contract and provided clarification on how that principle should be applied when there is a lack of observable data.

Accordingly, the Board tentatively decided that in determining the discount rates used to reflect the time value of money in the measurement of insurance contract, an insurer should use judgment to:

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

(b) 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.

Asymmetrical treatment of gains from reinsurance contracts

The 2013 ED requires an insurer to recognise immediately in profit or loss the amount representing the excess of the fulfilment cash flows and any pre-coverage cash flows over zero in a contract that is considered as onerous. However, any corresponding reimbursement from a reinsurance contract will adjust the CSM and will be recognised in profit or loss when the CSM is allocated in future periods. The asymmetrical treatment of the reimbursement from the reinsurance contract against the underlying insurance contract could result in an accounting mismatch.

The Board tentatively decided that an insurer should recognise in profit or loss any changes in estimates of cash flows for reinsurance contract that arise as a result of changes in estimates of cash flows for an underlying direct insurance contract that are recognised immediately in profit or loss. This tentative decision would allow the recognition of the benefit from purchased reinsurance contracts reinsuring onerous portfolios at the same time as the onerous portfolio loss is recognised through profit or loss.

This tentative decision applies to reinsurance contracts held regardless of whether the general accounting model or the premium allocation approach is applied when accounting for these contracts.

Level of aggregation

The Board tentatively agreed to clarify that the objective of the proposed insurance contract standard is to provide principles for the measurement of an individual insurance contract, but in applying the standard, an insurer could aggregate insurance contracts provided that it meets that objective.

The Board tentatively agreed to amend the definition of a portfolio of insurance contracts, as included in Appendix A, *Defined Terms*, of the 2013 ED. The amended definition for portfolio of insurance contracts will read as follows:

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

This new version of the definition removes the requirement for a portfolio to include only insurance contracts that are "priced similarly relative to the risk taken on". This deletion clarifies that portfolio are open ended and do not need to be closed when the insurer changes the price of the risk taken on.

Also, the Board tentatively agreed to specify that in determining the CSM or loss at initial recognition, an insurer should not combine onerous contracts with profit-making contracts (e.g. profitable contracts sold in prior years and that are part of the same portfolio). An insurer should consider the facts and circumstances to determine whether a contract is onerous at initial recognition.

The Board also tentatively decided to provide additional guidance on the application of the definition of portfolio of insurance contracts by including examples that explain the principle of combining insurance contracts for the purpose of determining the CSM at subsequent measurement.

Finally, the Board tentatively agreed that, in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* an insurer should select and apply its accounting policies consistently for similar contracts, taking into consideration the portfolio in which the contracts is included and the way the assets backing the liabilities from insurance contracts in each portfolio are accounted for. The reference to the assets backing insurance liabilities becomes required because of the Board's tentative decision to elect the accounting for time value of money of insurance liabilities via the Other Comprehensive Income ("OCI") as an accounting policy choice at individual portfolio level to be formulated under IAS 8 with due consideration to the elimination or significant reduction of accounting mismatches.

Accounting for contracts with participating features

During the education session held in May 2014, the Board discussed two proposed adaptations to the accounting for participating contracts that would result in an accounting treatment that would rely on the identification of underlying items. These adaptations are the accounting through the CSM for insurer's share of the underlying items and the use of a book yield approach to present the time value of money in profit or loss.

Accounting through the CSM for insurer's share of the underlying items

The Board tentatively agreed to consider in a future meeting the introduction in the new IFRS of a requirement for an insurer to adjust the CSM for the insurer's share of the underlying items on the basis that the insurer's share represents an implicit asset management fee. An implicit management fee should be considered to exist only when:

- the returns to be passed to the policyholder arise from the underlying items the insurer holds, regardless of whether the insurer is required to hold those items;
- there is a minimum amount that the insurer must retain; and
- the policyholder will receive a substantial share of the total return on underlying items.

Book yield approach to present time value of money in profit or loss

The Board discussed the mechanics of the book yield approach as it relates to the determination of discount rates to be used in recognising the time value of money (e.g. the effect of unwinding the discount) with a portion being presented in profit or loss and a second portion in OCI.

Under this approach, the book yield curve is determined at each reporting period end date based on the following:

(a) the underlying items held as at the reporting date and their accounting treatment for the current and future years until the period these items are expected to be sold or derecognised; and

(b) for the periods after these items are sold or derecognised, the future reinvestment assumptions based on the market information as at the reporting period end date.

When it is appropriate to apply the book yield approach

The Board tentatively agreed to consider in a future meeting to require an insurer to apply the book yield approach for determining the interest expense presented in profit or loss. The book yield approach should be applied only when the following criteria are met:

(a) the returns to be passed to the policyholder arise from the underlying items that the insurer holds, regardless of whether the insurer is required to hold those items or whether the entity has discretion over the payments to policyholder; and

(b) the policyholder will receive a substantial share of the total return from the underlying items.

Tentative decisions from 21 May 2014 IASB meeting

Allocation pattern for the contractual service margin

> Paragraph 32 of the 2013 ED provides that *"an entity shall 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 services that are provided under the insurance contract."*

The Board tentatively confirmed its proposals in the 2013 ED that the remaining CSM should be recognised in the profit or loss in a systematic way that reflects the provision of the service of insurance.

The Board tentatively agreed to provide additional guidance on the appropriate allocation pattern for the CSM of non-participating contracts. The Board tentatively decided that, for non-participating contracts, the service represented by the CSM is insurance coverage which is provided on the basis of the passage of time and reflects the expected number of contracts in force.

Fixed-fee service contracts

> Fixed-fee service contracts with a primary purpose of providing services and that meet all conditions set out in paragraph 7 (e) of the 2013 ED are scoped out from the requirements of the proposed insurance standard and will be accounted for under IFRS 15 *Revenue from Contracts with Customers*.
>
> Paragraph 7 (e) of the 2013 ED provides 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; and*
>
> *(iii) the insurance risk that is transferred by the contract arises primarily from the customer's use of services."*

The Board tentatively decided to permit, but not require, entities to apply IFRS 15 to fixed fee service contracts that meet all the criteria stated in paragraph 7 (e) of the 2013 ED.

Significant insurance risk

> Paragraph B19 of the 2013 ED provides that: *"a contract does not transfer insurance risk if there is no scenario that has no commercial substance in which the present value of the net cash outflows that is paid by the issuer can exceed the present value of the premiums."*

The Board tentatively decided to provide clarification on the guidance provided in paragraph B19 of the 2013 ED that significant insurance risk occurs only when there is a possibility that an insurer incurs a loss on a present value basis.

Contracts acquired through a portfolio transfer or a business combination

> Paragraphs 43-45 of the 2013 ED provides for the accounting of insurance contracts acquired through a portfolio transfer or a business combination.
>
> Other requirements in the 2013 ED are also applicable to insurance contracts acquired through a portfolio transfer or a business combination as provided in paragraph 46 of the 2013 ED.

The Board tentatively decided to amend the requirement of paragraphs 43-45 of the 2013 ED and to provide clarification that contracts acquired through a portfolio transfer or a business combination should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or the business combination.

Tentative decisions from 25 April 2014 IASB meeting

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.

Presenting insurance contract revenue and expenses

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 2014 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.

Proposed alternative model by European CFO Forum: accounting for participating contracts

Key principles of the alternative model

The alternative accounting model for participating contracts was developed using certain principles as enumerated below.

1. The accounting model is applicable to all types of participating contracts

The alternative accounting model will have a broader scope than that for the 'mirroring' approach as this model is designed to be applicable to all participating contracts, not just a subset of these contracts. In comparison, the 'mirroring' approach proposed in the 2013 ED is applicable only to participating contracts where an insurer is required to hold (by virtue of a contractual or statutory obligation) the underlying items that will affect the level of benefits due to the policyholder and this linkage to the returns of the underlying items is part of the contractual terms.

2. Single measurement basis for all insurance contracts

The alternative accounting model will follow the general building block approach for non-participating contracts, consequently removing the requirement to separate cash flows as required under the 'mirroring' approach. Also, options and guarantees will be treated in a similar way to other elements of the contract (e.g. insofar as the unlocking of the CSM is concerned, as explained in the third principle).

3. Contractual service margin is fully unlocked

For participating contracts, the contractual service margin ("CSM") will be unlocked for changes in financial and non-financial assumptions, thereby incorporating the effect of the change in the estimate of the projected future allocation to policyholders of their share of the returns from the underlying items and from those that will be in place following expected reinvestment options.

Allowing the full unlocking of the CSM for participating contracts will result in consistency in the measurement of the CSM both at initial recognition and at subsequent measurement.

The CSM cannot turn negative. Any changes in the financial and non-financial assumptions in excess of the CSM will be recognised immediately to profit or loss.

4. Profit recognition in accordance with the fulfilment of the contract as services are provided
Consistent with the 2013 ED proposals, the CSM will be recognised in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the insurance contract. For participating contracts, services provided by insurers to the policyholders include the provision of insurance coverage, administration of the contract and the provision of the service for the management of the underlying items.

A principle-based approach will be followed in determining the release pattern for the CSM under the alternative model. Insurers will need to determine at the inception of the contract the drivers for the release of CSM that best reflect the pattern of the services provided. Different drivers may be used for different types of participating contracts. However, regardless of which driver is used as a basis, the CSM is required to be fully released to profit or loss at the end of the life of the insurance contract.

5. The discount rate used to present interest expense in the profit or loss is determined consistently with the investment return recorded in the profit or loss for the assets which back the insurance contract liabilities
Steps in calculating the current portfolio book yield:

- Identify the underlying assets which back the portfolio;
- Determine the basis of the accounting return or book yield for those underlying items;
- Construct a yield curve based on the book yield at each reporting date covering the duration of the projected cash flows of the participating contracts; and
- Adjust the yield curve to incorporate assumed reinvestments to cover any duration mismatch between the insurance liabilities and the asset backing those liabilities.

6. Both the FVOCI and FVTPL applications are available as an accounting policy choice
This is consistent with the accounting policy choice provided for non-participating contracts in presenting the effect of changes in discount rates which the IASB tentatively decided during the 18 March 2014 meeting.

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 16 - 20 February 2015. The only remaining topic to be redeliberated by the Board is the accounting for participating contracts, including the transition requirements for these contracts.

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.

Deloitte understands that the redeliberations will continue during the first half of 2015 with the final Standard expected to be published in late 2015.

Designed and produced by The Creative Studio at Deloitte, London. 41349A