Insurance Accounting Newsletter

The last chance to influence the IASB on the new IFRS on insurance contracts – A closer look at the new proposals

Executive Summary

IASB has published the entire text of the revised ED but seeks comments on five key areas only.

Comments are due on 25 October 2013.

IASB published on 20 June its revised exposure draft ED/2013/7 on Insurance Contracts (the 2013 ED) which will remain open for comments until 25 October. This comment period may mark the final opportunity for the insurance industry to influence the new IFRS on Insurance Contracts expected to be released during the second half of 2014.

The 2013 ED represents a significant milestone in the development of this new IFRS and follows the IASB decision to re-expose the most significant areas developed since the publication of their previous proposal on 30 July 2010 (ED/2010/8, the 2010 ED).

Although the IASB has re-exposed the entire text of the draft IFRS it only seeks targeted comments on five areas, thus most parts of the new IFRS should be treated as nearly final. The five areas are those where the IASB judged there was significant change from the original model presented in the 2010 ED.

Deloitte has published IFRS in Focus: *IASB re-exposes proposals on insurance contract accounting* providing a concise summary of the revised exposure draft ED/2013/7 (http://www.iasplus.com/en/publications/global/ifrs-in-focus/2013/insurance-ed).

These areas are:

i. Adjusting the unearned profit to reflect changes in cash flows for future services.

ii. Splitting interest expense between profit or loss and other comprehensive income.

iii. Transition provisions for the first application of the standard with a modified retrospective application of all the new requirements.

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

v. Presenting insurance contracts' revenue and expenses.

On 27 June the FASB published an exposure draft of a new US pronouncement for insurance contracts. This document presents the new accounting model for insurance contracts that has been developed jointly with the IASB. However, as commented in several past issues of our Insurance Accounting Newsletter, the proposal is not fully converged with the 2013 ED of the IASB and material differences remain. These are not covered in this issue of Deloitte's Insurance Accounting Newsletter. Finally, from a due process perspective, the US exposure draft is open for comments on the entire model given that FASB had only published a discussion paper in 2010.

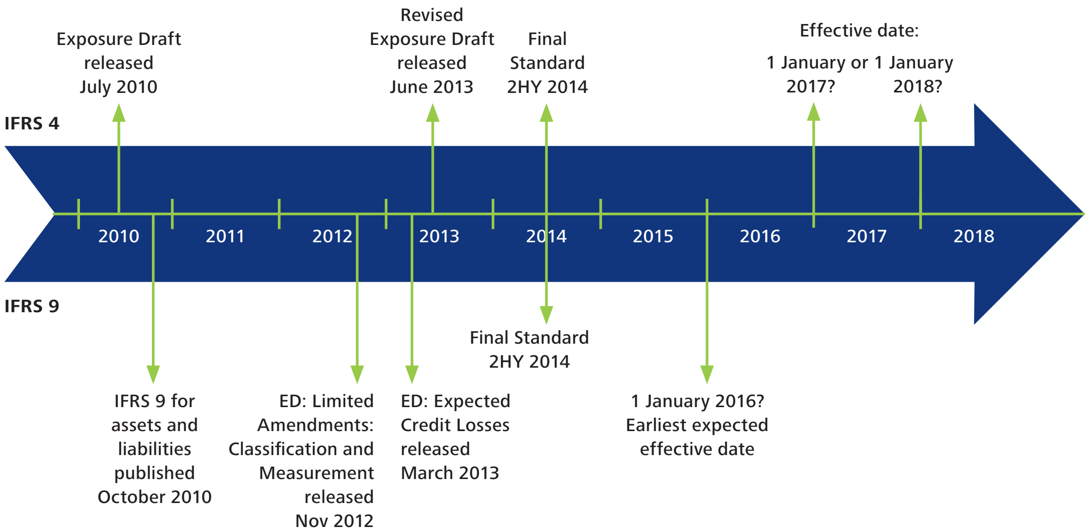
With the publication of these two important draft pronouncements only the IASB gave indication of the possible effective dates for their new insurance regime. The IASB proposes to allow approximately three years from the publication date of the final IFRS planned for the second half of 2014. This means the new IFRS would not be mandatory earlier than 1 January 2017 and 1 January 2018 may be more likely if the final redeliberation process is time consuming and the IASB continues to operate with meetings being held only on a monthly basis. FASB has decided to seek direct input from its constituents on the time needed for implementation and they would set the effective date during their redeliberation phase in the winter.

Effective date of the final standard is approximately three years from the date of its publication, planned for second half of 2014.

Early application permitted.

Of equal importance to insurers is the IFRS 9 Financial Instruments effective date that would materially change the accounting for their financial assets. As previously reported in our Newsletter series, IFRS 9 effective date has now been "decoupled" from that of the new IFRS for insurance contracts and it is likely to occur from one to three years earlier as represented in the diagram below. The delays in the finalisation of the new credit impairment model suggest that the IASB is likely to pass a second amendment to the IFRS 9 effective date. Deloitte estimates that in this eventuality the IASB is likely to shift by at least twelve months to 1 January 2016.

This edition of the Deloitte Insurance Accounting Newsletter focuses on those areas of the 2013 ED where the IASB seeks feedback and describes the considerable business challenges which lie ahead for the insurance industry to address these areas.



Measurement proposals – Adjusting the unearned profit to reflect changes in cash flows for future services

One of the most significant changes since the 2010 ED was released is the IASB decision to unlock the **contractual service margin** (CSM, formerly known as the residual margin) for changes in estimates of cash flows for future coverage and other future services.

The IASB is now convinced with the concept of CSM as representing the profit expected from insurance contracts as a result of the premiums being paid ahead of the insured events generating the associated cash flows.

Unchanged from the 2010 ED the CSM is deferred on initial recognition as an explicit component of the insurance liability. The IASB was, however, persuaded that locking the amortisation of CSM at inception would not reflect accurately the future profitability of insurance contracts and would result in counter intuitive results such that the release of CSM to profit or loss would have continued also even when the portfolio of contracts had turned onerous.

The new approach requires the recalibration of the unearned profit element of the insurance contract (the brought forward CSM balance) during the subsequent measurement of portfolios of insurance contracts. Under this revised approach, the insurer would recognise the changes in the insurance liability that relates to expected future cash flows associated with future unexpired coverage as an equal and opposite adjustment to the CSM. Thus, there would be no profit or loss arising from changes in assumptions about future cash flows.

Effectively, IASB shifts from a view of the CSM being considered as a mere day one balancing figure (residual) of the building blocks liability to a balance that plays a more dynamic role in faithfully representing the unearned profit element of an insurance contract at each reporting date. The renaming of the residual margin to CSM aims at pointing out the ability of this measure to capture the expected future profitability in an insurance contract and the new accounting process attempts to allocate it objectively and consistently throughout the period of the policy coverage and in light of the revised estimates of future fulfilment cash flows.

In applying this view, unless the portfolio of insurance contracts that the contract belongs to is onerous at initial recognition, an insurer shall determine the amount of contractual service margin at initial recognition as an amount equal and opposite to the fulfilment cash flows or more simply as the difference between the present value of inflows and outflows, including risk adjustment. It is evident that if cash outflows increase, the contract becomes less profitable whereas if the cash outflows decrease the contract becomes more profitable with the opposite being true for future inflows. The new unlocking mechanism requires that if the increase (or decrease) in the net cash outflows relates to cash flows that relate to future coverage or other future services, the difference would not adjust the current period profits but would instead reduce (or increase) the CSM liability. Therefore, changes that would reflect a reduction in estimates of future profit from an insurance contract would be offset against the CSM and recognised through profit or loss only when the CSM is released to profit or loss in future periods as a result of the insurer fulfilling its contractual obligations over the coverage period.

The IASB introduced a limit on the amount by which the CSM could be decreased as a result of unfavourable changes, this limit being that the CSM should not turn negative. If the changes are so adverse that would cause the CSM to become negative at the level of a portfolio, this would result in an onerous contract liability that should be recorded immediately in profit or loss after releasing all of the CSM brought forward.

On the other hand, if changes in estimates of future cash flows are positive in a way that they would increase the future profitability of the insurance contract, this increase would be added to the CSM and recognised through profit or loss on fulfilment of the coverage and service obligations. The IASB did not impose a limit on the amount by which CSM could be increased as a result of favourable changes.

Key considerations in unlocking of CSM

The principle that the CSM would be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services comes with a number of important pieces of application guidance:

a) Changes in estimates of incurred claims would always be recognised in profit or loss;

b) The CSM would be adjusted for experience differences if they relate to future coverage i.e. higher or lower collection of premiums in the period that relate to future coverage would adjust the CSM rather than being recognised through profit or loss;

c) Delays or accelerations of repayments of investment components would not necessarily result in adjusting the CSM unless the change in timing affects the cash flows related to future services; and

d) For those contracts which have asset dependent cash flows the CSM would be adjusted only if those asset dependent changes trigger a change in future cash flows associated with future coverage or services (for example future asset management fees). However, gains or losses from the valuation of those assets would not trigger an adjustment in the CSM as they do not relate to the insurance contract's unearned profit and would instead be recognised immediately in profit or loss or in other comprehensive income.

The 2013 ED amended the requirement from the 2010 ED so as to accrete interest on the contractual service margin using the market consistent discount rate determined at initial recognition and in addition, it required that this discount rate is not subsequently changed to reflect the current market interest rates at the reporting date. This requirement aims at making the process of interest accretion simpler. It provides useful information because it is linked with the insurers expectations priced at inception and it is aligned with the accounting for time value of money through profit or loss required under the 'OCI solution' described below.

Unit of account for CSM

The 2013 ED specifies the level of aggregation of contracts required to initially and subsequently determine the CSM. This requires that at initial recognition the CSM is calculated at the same portfolio aggregation as the fulfilment cash flows (inclusive of the risk adjustment). Given that the expected present value of cash flows is the statistical mean of the underlying probability distribution the aggregation is the same as the risk adjustment. This approach ensures that all diversification benefits associated with the risk adjustment calculation are captured in the CSM and do not flow through profit or loss.

The accounting for the CSM in subsequent measurement has now two dimensions.

The first dimension is the reduction of the CSM as a result of the fulfilment of contractual obligations is more granular because the 2013 ED requires that it should be determined at a level of aggregation such that once the coverage period has ended for a given contract, the CSM related to such contract is recognised in profit or loss.

This does not preclude the insurer from using a group of contracts as an acceptable level of aggregation for the accounting of the CSM and it is likely that a common initial recognition date (or dates if sufficiently close to each other) and a common coverage period are necessary parameters for the definition of such groups. A third factor would also be necessary to faithfully account for the release of CSM to profit or loss. This factor would be the pattern that an insurer would design to achieve the principle of paragraph 32. Different patterns may apply to sub-sets of contracts that have been initially recognised in the same period and with similar coverage periods thus requiring a further subdivision of the aggregate of contracts.

CSM may increase or decrease as a result of changes in estimates of expected cash flows for future coverage but cannot turn negative.

At subsequent measurement, the level of aggregation for CSM can be at a more granular level than that use at initial recognition.

The level of aggregation chosen should ensure that the CSM is fully recognised to profit or loss at the end of the coverage period of an insurance contract.

The second dimension is the unlocking of the CSM to be carried out at the level of portfolio, which is defined in the 2013 ED as "a group of insurance contracts that: (a) provide coverage for similar risks and that are priced similarly relative to the risk taken on; and (b) are managed together as a single pool." This means that within the same portfolio the insurer can use the cohorts of CSM recognised across the various years in which the portfolio has been in place to calculate the impact of changes in future cash flows. The 2013 ED would not require the testing of the CSM at individual cohort basis thus the negative and positive changes that may be attributable to each cohort would need to be considered in aggregate at portfolio level. The resulting adjustment of the CSM would need to be applied proportionally across all the CSM cohorts. However, losses on new business could not be offset against the CSM on existing cohorts in the same portfolio.

Presentation proposals – Presenting the change in the liability due to discount rates changes in Other comprehensive income(OCI)

To address the impact of market interest rate fluctuations on insurance liabilities and the bonds backing them the IASB mandated the split of the unwinding of the discount rate of an insurance contract (i.e. interest expense) between OCI and profit or loss and in parallel introduced a new measurement category for financial assets that accounts for certain debt instruments at fair value with fair value changes recognised in OCI and amortised cost accounting utilised for the profit or loss.

The 2013 ED requires that interest expense recognised in profit or loss shall always be calculated using the historical market discount rates applied at initial recognition.

The revaluation of the insurance liability using discount rates derived from current market interest rates will instead be recognised through OCI. The OCI amount would be calculated as a difference with the same set of fulfilment cash flows calculated using the two sets of discount rates.

This approach would essentially require insurers to maintain two sets of balance sheet records: one utilised for the actual balance sheet determined with current market interest rates and another only used for profit or loss which is calculated with a series of historical discount rates going back in time to the rates applied for the initial recognition of the oldest insurance contracts liability in-force at the reporting date.

This requirement applies to all types of cash flows from insurance contracts irrespective of whether they are associated with unexpired coverage or incurred claims.

Linkage of revised ED requirements with IFRS 9

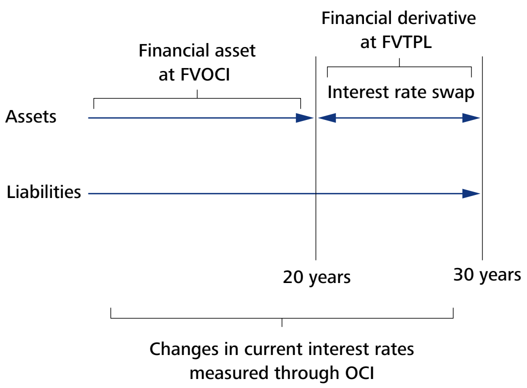
As noted above, in parallel with the 'OCI solution' for insurance contracts the IASB has also published a proposed amendment to IFRS 9 standard, "Financial Instruments: Classification and Measurement" where they proposed to introduce a new financial asset measurement category: debt instruments at fair value through other comprehensive income (FVOCI).[1]

This category requires the fair value changes in certain debt instruments to be accounted for within OCI with amortised cost accounting being required for the profit or loss. This new category of financial assets is available only if the cash flow characteristics required for financial assets to be accounted for at amortised cost are in place and they are managed according to a 'hold and sell' business model.[2]

The combination of these decisions on financial assets and insurance liabilities aims at segregating the effects of the underwriting performance from the effects of the changes in the discount rates that unwind over time. This approach was developed by the IASB following main concern from insurers that the proposals in the 2010 ED would have introduced material accounting mismatches. The magnitude of changes in the liability and financial assets driven by current discount rates and the different accounting treatment received would have overshadowed or masked the operating performance of an insurer if recognised in full through profit or loss.

However, the IFRS 9 proposed presentation of the change in current market rates through OCI for simple debt instruments may not always be sufficient to address the issue the IASB aimed at resolving with these parallel proposals.

For example, if the liability duration exceeds the duration of the underlying assets and an insurer hedges these duration mismatches with derivatives the effects of the 'OCI solution' would not apply to these derivatives and their changes in fair value would flow through profit or loss.



1 http://www.iasplus.com/en/publications/uk/need-to-know/ifrs-9-limited-amendments

2 These are financial assets that contain contractual cash flows that are solely payments of principal and interest; and are managed as part of a business model whose objective is both to collect contractual cash flows and for sale

As illustrated in the above diagram, the consequence for insurers with insurance liabilities from non-participating contracts (e.g. fixed annuities) will be to effectively have an accounting mismatch between the change in the current discount rate shown in OCI and the change that the same fluctuation of market interest rates will have on the derivatives acquired for hedging the duration mismatch and protect the insurer from reinvesting in assets after twenty years that may not yield sufficient interest to cover the unwinding of the fixed insurance cash flows. IFRS 9 requires the change in fair value for those derivatives to be presented in profit or loss.

As discussed below in the transition section, the IASB has permitted insurers to re-designate their financial assets backing insurance liabilities in the FVTPL category if by doing so they would eliminate or significantly reduce an inconsistency in the measurement or recognition that would have been created by the application of the new insurance contracts standard (paragraph C11 of the 2013 ED). However, this option does not address the derivative presentation described earlier.

The combined effect of the 'OCI solution' for financial assets and insurance liabilities has other important implications when there are changes in credit spreads.

Determination of discount rates

The 2013 ED adopts the option to determine the discount rate for insurance liabilities using either the "top-down" or "bottom-up" approach to adjust the current market interest rates and obtain a current discount rate curve to be applied to insurance liabilities. In particular, the "top down" approach allows the removal of credit risk spreads from debt instruments to determine the implicit illiquidity premium retained in the insurance liability discount rate.

The recent financial crisis displayed several material instances where credit spreads widened for sovereign and corporate debt instruments. If insurers were applying the 2013 ED in that period they would have likely held their financial assets in the FVOCI category. Based on Deloitte's own survey most insurers intend to utilise the "top down" approach to set their discount rates. We are of the view that the combined effect of these accounting approaches would have removed from the profit or loss the volatility caused by the market turbulence and it would have accounted for it through OCI. The fact that these changes would unwind over time due to the illiquid and long term nature of insurer's asset-liability positions would have kept these changes separate from the period profit or loss. Equally, its impact would have been fully visible through OCI and on the balance sheet of insurance companies suggesting that the 'OCI solution' would be effective at delivering a faithful representation of insurers' performance in that period except for the recognition of fair value gains and losses on derivatives hedging material duration mismatches.

Deloitte in their comment letter response to IFRS 9 revised ED for classification and measurement in March 2013, have recommended to the IASB to develop a solution that considers life insurers' duration hedging practices to improve the 'OCI solution' proposed in the IFRS 9 amendments and in the 2013 ED.

"While we welcome the IASB's intention to resolve some of the accounting issues for insurers, we see some challenges in applying the fair value through OCI business model on some assets purchased to match the insurance liabilities. The newly introduced business model does not cater for duration mismatched assets that back insurance liabilities where the duration gap is closed using derivatives, as the derivatives will always be held in a fair value through profit or loss business model.

[…}

We ask the Board to consider, as part of its macro hedging accounting project, the use of derivatives by insurers to hedge the duration mismatch arising between financial assets and insurance liabilities. The use of macro hedging accounting could alleviate some of the income volatility that cannot be resolved by the introduction of the third measurement category as proposed in this ED."

As noted above, the operational consequence of the decision to mandate the split in the presentation for the change in discount rates between the OCI and the statement of profit or loss can be described as if insurers have the need to maintain two balance sheets:

a) One to feed the unwinding of the interest accreted at the locked in rate at inception in the statement of profit or loss and;

b) A second one to feed the change in the current discount rate to the locked in rate presented in the OCI. This would also be the balance sheet amount included in the financial statements.

The impact of this presentation will also feed into the underlying actuarial models because they would only be permitted to develop assumptions on interest-sensitive cash flows using the balance sheet based on current interest rates (described under b) above).

Effectively, insurers will be required to develop two balance sheets to reflect different presentation of interest rate changes.

The 2013 ED explains that "using other comprehensive income to recognise the effect of changes in interest rates on interest-sensitive cash flows in other comprehensive income would mean that the amounts included in other comprehensive income would not unwind over time. This is because the changes in interest rates would result in changes in the payments to policyholders. This approach would therefore be inconsistent with the IASB's rationale for recognising changes in other comprehensive income, which is that underwriting and investing performance should be segregated from changes that unwind over time." In practice this means that the actuarial models would calibrate all their assumptions on current market interest rates and then be run a second time to calculate the time value of money that should be included in profit or loss.

One final characteristic of the 'OCI solution' is the mechanism for recycling through profit or loss the amounts recognised in the accumulated OCI balance. The 2013 ED requires that when an insurance contract is derecognised (either because of the fulfilment of all the associated obligations or because of a substantial modification as described in paragraph 49) the amounts in OCI would flow through profit or loss. This event would occur when an insurance contract is derecognised earlier than expected.

Transition

One of the key areas the IASB is asking for feedback in the 2013 ED is the approach to transition. A key difference with the 2010 ED and of particular importance to insurers with long-term coverage contracts is the requirement to restate the CSM for the policies in-force at the transition date. The CSM of in-force policies represents the major source of IFRS accounting profit, particularly for the long term insurers.

The IASB was convinced to depart from its previous position in 2010 ED which mandated no margin recognition on transition after the overwhelming concerns raised from the majority of respondents highlighted the concern that profits deferred under the previous accounting policies for unexpired coverage would never be recognised in statement of profit or loss and thus distorting the representation of economic reality in the financial statements.

Deloitte via its 2010 Comment letter was among the first to support the recalibration of the CSM at transition and although acknowledging the significant costs and difficulties surrounding a full retrospective application, Deloitte believed that setting the CSM for in-force contracts at zero at the date of transition does not represent faithfully the underlying economics (i.e. the profitability) of the in-force portfolio.

The new transition proposals call for full retrospective restatement of the CSM. However, in cases where retrospective application would be deemed impracticable (based on the guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) the new proposals introduce some practical expedients and certain simplifications which aim to make the restatement exercise more manageable for insurers and to extend the retrospective restatement of the CSM as far back as the oldest in-force contracts would demand.

The potential impact of the new transition requirements can be analysed against these elements of the new accounting model:

- **Carrying amount of the insurance liability** for contracts in force at the beginning of the earliest period presented. An insurer shall measure the insurance liability at the *expected present value of the fulfilment cash flows* arising from the portfolio of contracts plus a *risk adjustment* and a *CSM*.

  The CSM represents the unearned profit element of the in-force portfolio as restated on transition which is going to be recognised in profit or loss after transition and over the remaining coverage period of the in-force contracts.

- **Deferred acquisition costs** carried on the asset side of the statement of financial position prior to transition. Any existing balances of deferred acquisition costs would no longer appear on the statement of financial position. Accordingly, the directly attributable acquisition costs should now be included in the cash flows used to determine the insurance contract liability.

- **CSM** needs to be determined retrospectively from inception date for all insurance contracts that are in force at the transition date. No CSM is recognised for insurance contracts for which the coverage has already expired (i.e. incurred claims liabilities). In order to determine the CSM at transition date an insurer is required to go back at contract inception, calculate the CSM based on the new accounting principles and allocate it over the time running from inception to the transition date. The CSM that derives from this exercise at the transition date (or at the earliest period presented) is then added to the expected present value of the fulfilment cash flows plus the risk adjustment and represents the unearned profit element that would be brought forward on transition and recognised through profit or loss in future periods.

  Insurers shall assume that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition. Similarly the risk adjustment at transition date is assumed to be the same at initial recognition. These practical simplifications are introduced as a requirement to use the benefit of 'hindsight' and practically overcome the need to calculate the effect of 'unlocking' the CSM for the period from the contract inception up to the transition date due to subsequent changes in cash flows.

At transition, insurers are required to retrospectively apply the provisions of the insurance contracts standard to all prior periods. However, practical expedients and simplifications have been provided where full retrospective application is deemed impracticable.

The 2013 ED requires the insurer to apply retrospectively as far as is practicable. However it also introduces some additional simplifications to this rule when the retrospective application is impracticable. When it is not practicable to retrospectively restate the CSM, the insurer is required to estimate the CSM using all of the objective information that is reasonably available but with the efforts not expected to be 'exhaustive'. The 2013 ED stresses that in cases where retrospective application is impracticable, an insurer should make an effort to estimate the CSM by maximising the objective data and that the calibration of the CSM to any margin included in the insurance liability before transition as measured using previous GAAP should be avoided.

The restatement of the CSM must be completed at the level of granularity that allows the subsequent accounting described above. This means grouping contracts in light of their inception date, duration and the underlying fulfilment patterns.

- **Opening OCI balance at transition.** A restatement would be required in the opening OCI balance to take into effect the 'OCI solution' for the in-force portfolio at transition as discussed earlier. The practical implementation issue that arises here is the determination of the discount rate at the date of initial recognition for the in-force portfolios at transition. This locked-in discount rate is required in order to calculate the cumulative effect of the difference between the expected cash flows at the date of transition discounted using that rate as would have been determined at the inception date and the expected cash flows based on the current rate as determined on transition date.

  The 2013 ED provides guidance to explain how to determine the discount rate at inception for in-force contracts which go several years back in time.

  i) An insurer shall first find an appropriate yield curve that would be used to determine the discount rate for its in-force portfolio at the date of transition based on the new requirements. If there is an observable yield curve that approximated that yield curve for a period of at least 3 years before the date of transition, the insurer shall use that observable yield curve to determine the discount rates for its portfolios at the date of initial recognition of each associated insurance contract.

  ii) If that observable yield curve as explained above does not exist, the insurer shall apply a spread (averaged over at least three years if possible) between an observable yield curve that most closely approximates the current yield curve determined at the date of transition. Then it should use this observable yield curve plus or minus the relevant spread in order to derive the discount rate that should be applied to its portfolio at the date of initial recognition (the locked-in rate).

- **Revenue recognition in the future periods after transition for the in force portfolios at transition date.** On transition to the new accounting standard an insurer would be required to present revenue and expenses in the statement of comprehensive income for the reporting period on or after the effective date and for all comparative periods presented. An insurer will use assumptions used in the measurement of a component of the insurance contract liability to estimate the amount of the revenue recognised by reference to specific changes in the insurance liability.

- **Transition requirements for insurance contracts previously acquired through a business combination.** The 2013 ED requires an insurer to account for the in-force contracts acquired through a business combination using:

  a) the date of the business combination as the date of inception of those contracts; and

  b) the fair value of those contracts at the date of the business combination as the premium received.

  This means that the key date for the estimation of the locked-in discount rate that will be used for the retrospective application of the 'OCI solution' and for the calculation of accretion of interest on the CSM is the date of the business combination.

  In addition, the restatement of insurance contracts previously acquired through a business combination will require any resulting gains or losses to adjust retained earnings rather than goodwill.

  Where the business combinations were dated many years back, even before IFRS 3 became effective, fair value information may not be practically available. In this situation the CSM would be estimated by maximising the use of objective information available. This could include various estimation techniques, such as:

  a) Estimating the CSM by reference to the existing contracts, adjusting for different factors that might differentiate the margin in different periods; or

  b) Estimating the CSM by using historical assumptions about the profitability of similar contracts.

- **Redesignation of financial assets.** Under the transition rules of the 2013 ED, an insurer would be permitted, but not required to re-designate financial assets in the fair value through profit or loss (FVTPL) category if doing so would eliminate or significantly reduce a new inconsistency in the measurement or recognition that would have been created by the application of the new IFRS on Insurance Contracts. Furthermore, if the insurer has already applied IFRS 9, it is permitted to:

  a) Make a new election to use the Fair Value through OCI (FVOCI) option in order to present changes of some or all of its equity securities that are not held for trading;

  b) Revoke a previous election to use OCI to present changes in the fair value of some or all of its equity securities that are not held for trading.

  In addition, an insurer is also **required** to revoke previous designations of financial instruments as measured at FVTPL if the initial application of the new IFRS on Insurance Contracts eliminates an accounting mismatch that led to the previous designation.

Key operational challenges on transition

The practical expedients and simplifications designed to make the transition rules more practical and cost-effective confirm that the transition exercise still remains a huge and burdensome task accompanied by a number of operational challenges especially for insurance companies with portfolios of in-force contracts that were incepted/acquired many years earlier.

In many cases, restatement data may not be available for certain long-duration or long-tailed contracts due to number of reasons such as systems or data transformations that may have caused loss of data in the past or due to acquisitions or sales of companies and portfolio transfers. In these cases, the effort to identify objective information for these contracts is of paramount importance.

To maximise the level of accuracy surrounding the calculation of the CSM at transition date, insurers will have to collect information at cohort level (i.e. grouping contracts with the same inception and duration period) to ensure that the CSM is reasonably calculated.

This data mining will not be an easy task for several insurers and planning early on their approach to gather data for the retrospective calculations is likely to be wise. This kind of planning may reduce significantly the time and cost commitment in the data collection exercise ahead of the effective date of the new IFRS. This activity would include, for example, the identification and categorisation of the specific data that need to be gathered for each portfolio of contracts and then the identification of the systems or data warehouses from where these data need to be extracted.

Other considerations would apply to insurers depending on their jurisdiction. For instance, Eurozone insurers may want to consider the data collection from contracts issued at the time they were denominated in national currencies prior to the Euro adoption.

From a systems perspective, insurance entities will need to evaluate whether their current systems and software applications can support and run the new calculations for the in-force portfolios and if not what is their systems' flexibility to customisations in order to produce the desired results under the new IFRS.

The transition to the new rules for measuring the accounting profit is likely to have some implications on the tax front. The new reconciliation from accounting to taxable profits will have as a starting point the 'new' accounting profit that will be calculated based on different and new principles. Insurers would need to consider the impact of the transition to the new IFRS in their tax planning and strategy and how the new insurance accounting profit will affect both current and deferred tax figures.

Insurance companies will be given approximately a three year period between the date of publication of the new IFRS on Insurance Contracts and the date of its mandatory application. Early application would be permitted.

Measurement proposals – Measuring and presenting cash flows from contracts with contractual link to underlying items

One of the areas where the different accounting treatment of insurance liabilities and financial assets backing them is most sensitive is that of participating contracts. This form of insurance has taken many different facets but all of them offer to policyholders a kind of contractual arrangement that awards them a return based on financial assets that the insurer holds in a participating fund. Participating contracts have become an extremely popular form of insurance contracts to fund pension plans and represent the most material liability for the life insurance industry with equally material portfolios of assets backing them.

The 2013 ED concludes that when an insurance contract has cash flows which vary with the returns on underlying items a new measurement and presentation approach would be required to ensure accounting mismatches with the participating assets are eliminated.

The 2013 ED classifies as participating contracts all those where the cash flow linkage with underlying items is directly traceable. This link may also depend on the insurer's discretion (e.g. often insurers have the discretion to decide how much from the participating items goes to policyholders). The 2013 ED also clarifies that the contractual arrangement that establishes the policyholder's right to participate in the underlying items may arise from contract, law or regulation. Finally, the underlying item is defined quite broadly as one of:

i) the returns from a specified pool of insurance contracts or a specified type of insurance contract;

ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

iii) the profit or loss of the entity or fund that issues the contract.

The amounts which are distributed to policyholders at the insurers' discretion would be influenced by factors such as the level of return that the underlying items have produced in a given period, competitors' distribution rates, mortality and expense experience.

The 2013 ED retains[3] the principle already established in the 2010 ED that the discount rate *"shall be consistent with other estimates used to measure the insurance contract to avoid double counting or omissions, for example:*

a) *to the extent that 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, the characteristics of the liability reflect that dependence. The discount rate used to measure those cash flows shall therefore reflect the extent of that dependence."*

However, for participating contracts, the 2013 ED goes further than this and it requires that the measurement and presentation of the changes in the cash flows that vary directly with the underlying items is based on the carrying amount of the underlying items. The intention of this requirement is to eliminate any accounting mismatch where the cash flows and the underlying items are economically matched. This requirement has been called the 'mirroring approach' because the measurement and presentation of the liability cash flows is a mirror image of the accounting basis adopted for the underlying item.

Given this requirement is completely different from the overall measurement basis adopted for all other types of insurance contracts (a risk weighted present value of future cash flows or building blocks approach – BBA), the 2013 ED stipulates that this requirement would take precedence over all other requirements including the 'OCI solution' and the unlocking of the CSM described above.

The requirements that apply to these contracts are set out in paragraph 66 of the 2013 ED where the decomposition of the cash flows of all contracts subject to the mirroring approach and the associated accounting treatment is described:

1. cash flows that vary directly with the underlying item would be accounted for using the 'mirroring approach' and both measurement and presentation would follow the mirror treatment. No unlocking of the CSM is permitted for changes in this component of the contract's cash flows;

2. cash flows that vary indirectly with the underlying items such as embedded options and guarantees that are not unbundled will be accounted for using the BBA that applies to all other insurance contracts. However, all the resulting changes must always flow through profit or loss without the benefit of the 'OCI solution' or the unlocking of the CSM; and

3. cash flows that do not vary with the underlying item would be accounted for using the BBA inclusive of the 'OCI solution' and the unlocking of the CSM.

Insurers will need to decompose the different sets of cash flows in a single contract that is subject to mirroring approach.

The key accounting judgment in the application of these requirements is how to decompose cash flows that are part and parcel of a single contract. The 2013 ED has set out the decomposition principles in paragraph B85 where it states that an insurer must decompose the cash flows *"in a way that maximises the extent to which the measurement both: (a) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and (b) maximises the minimum fixed payment that the policyholder will receive."*

The 2013 ED provides evidence of the challenges from this requirement in paragraph B86 where three alternative decompositions of a contract that guarantees the return of CU 1,000 premium paid or the higher value of 90% of the assets acquired on initial recognition of the policy are presented and discussed. The 2013 ED explains how only one of them would meet the decomposition requirements. Under this approach the application of principle (a) above would result in the cash flow equivalent to 90% of the assets being subject to the mirroring approach (cash flow sub-set 1 above). The capital guarantee would instead be decomposed in compliance with principle (b) above as if there was a fixed cash flow of CU100 (10% of the initial premium) and an option to collect 90% of the excess of the asset value over CU 1,000. This split would maximise the minimum fixed cash flow sub-set (sub-set 3 above).

The practical implications of this decomposition approach are with the actuarial models that would need to carry out such calculations. It is very likely they would have not been designed to operate on that basis.

3 Paragraph 26(a) of the 2013 ED

The implementation of this requirement presents other practical issues such as the treatment of underlying assets associated with "orphan estates" which represent undistributed surplus assets of an underlying participating fund that are not specifically linked to in-force insurance contracts. The principle established in the 2010 ED and confirmed in the 2013 ED that "payments arising from existing contracts that provide policyholders with a share in the returns on underlying items (see paragraph 33), regardless of whether those payments are made to current or future policyholders" would indicate that the new IFRS will require the underlying items on the "orphan estates" to be used to measure the cash flows to future policyholders if no attribution to current policyholders is estimated.

Together with the introduction of the 'mirroring approach' the 2013 ED also introduces an amendment for all other insurance contracts where the cash flows are expected to vary directly with returns of an underlying item but are not subject to the 'mirroring approach' because there is no requirement (from contract, law or regulation) for the insurer to actually hold the underlying item.

In these instances the 2013 ED does not require the decomposition of the contractual cash flows. Instead it requires that the whole contract be valued using the BBA with the only exception being that the interest expense presented in the statement of profit and loss is determined with a discount rate that reset under certain circumstances. The requirement to reset is dependent on the insurer's revised expectations 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 using the requirements of the 'OCI solution'.

It is possible that the resetting frequency would vary depending on the underlying item that the insurer refers to in designing and managing these contracts. For example in an index-linked insurance contract the reset would be very frequent and the interest expense recognised through statement of profit and loss is unlikely to leave any residual balance in the OCI. Other contracts may be funded by a more stable asset mix (e.g. a portfolio of fixed income securities) and the insurer's expectations would be to accrete policyholders' benefits by reference to the flows of interest and principal cash flows. In this instance it is plausible that the insurer would not reset the discount rate for the profit or loss presentation even if the market interest rates fluctuate significantly.

As noted above the requirement to reset applies to all insurance contracts when there is an asset dependency on the value of the contract's cash flows. The 2013 ED clarifies that this would be the case regardless of whether:

a) The transfer of the expected returns of those assets is the result of the exercise of insurer's mere discretion (i.e. it is not a discretionary participation feature).

b) The specified assets are not held by the insurer and the 'mirroring approach' set out in paragraphs 33-34 of the 2013 ED does not apply.

In conclusion, whilst the 'mirroring approach' has been designed to help manage accounting mismatches and seems to have theoretical merit, the valuation and actuarial models required to implement it in practice may present material operational challenges for insurers, particularly around the decomposition of cash flows.

The effect of these requirements combined with the requirements that have been confirmed from the 2010 ED is to create four main categories of insurance contracts with different measurement requirements applicable to them. In summary these are the categories of insurance contract measurement from the 2013 ED:

Category	Summarised measurement requirements
a) Contracts where the simplified approach to measure the pre-claim liability can be elected.	The pre-claim liability is measured with reference to premiums receivable. The liability for incurred claims follows the BBA.
b) Contracts with a specified link to underlying items that the insurer is required to hold (e.g. participating contracts).	The liability must be decomposed in up to three sub-sets (as applicable): • 'mirroring approach' component • BBA with all changes through profit or loss • BBA
c) Contracts where the cash flows depend on underlying items that the insurer is NOT required holding (e.g. index-linked contracts).	The liability follows the BBA with an amendment to the principles setting the discount rate for interest expense presented through profit or loss (requirement to reset the rate rather than to keep the rate locked-in).
d) Contracts where the cash flows do not depend on underlying items (e.g. non-participating contracts).	The liability follows the BBA.

Presentation proposals – Presenting information on insurance contract revenue

The 2013 ED replaces the summarised margin presentation proposed in the 2010 ED as a response to the criticism that the 2010 ED did not include volume of an insurer's activity as prominent information in the statement of comprehensive income.

The 2013 ED proposes: (1) for all insurance contracts measured under the BBA to decompose the result of those calculations such that a gross presentation of revenue is achieved in line with the principles that will be set out in the new IFRS on revenue from customer contracts and (2) prohibit the recognition of premium collected from insurance contracts as revenue when it contains a payment of cash that would be returned to the policyholder (or related parties) irrespective of the occurrence of the insured event (i.e. all bundled deposit components in an insurance contract).

It was always the intention of the new IFRS on Insurance Contracts to align the presentation of underwriting performance within the statement of comprehensive income to the proposals currently being developed in the IFRS "Revenue from Contracts with Customers" (this new IFRS is expected to be released later in 2013). In formulating the 2013 ED it was clear that the presentation proposed under the Premium Allocation Approach (PAA) already included in the 2010 ED provided an approach that would satisfy users' need to assess the volume of activity from those contracts and that was deemed consistent with the new IFRS on Revenue.

However, based on comments received on the 2010 ED, several recommendations suggested that not providing information on the volume of activity from insurance contracts on the face of the statement of comprehensive income for those contracts which are measured under the BBA proposals would not help users. The 2013 ED introduces a new definition of revenue for insurance contracts under the BBA.

To produce this revenue amount an insurer will have to develop a reporting model which will effectively disaggregate the output from the BBA into two separate tranches:

1. liability for the remaining coverage (LfRC)- which measures the insurer's obligation to provide service or coverage to the policyholder over the coverage period; and

2) liability for the incurred claims (LfIC) – which measures the insurer's obligation to investigate and pay claims that have already occurred, including incurred but not reported claims.

The revenue figure will be determined from the changes associated with the LfRC. This liability has exactly the same nature of the pre-claim liability under the PAA. However, the long duration, the multiplicity of cash flows that would arise over that period and the presence of embedded options and guarantees demand additional requirements to isolate the changes in the LfRC that ought to be presented as insurance revenue.

The first requirement that the 2013 ED introduces is that the revenue amount should include the changes in the CSM that reflects the transfer of services in the period and the changes in the risk adjustment for the LfRC. The former amount represents the expected release of the unearned profit from the balance at the start of the period. The latter is the change of the risk adjustment liability associated with the uncertainty of future coverage cash flows. The change in the risk adjustment can be either positive or negative. The sum of these two amounts should be added to the expected claims included in the opening LfRC. It would appear that the possibility for the risk adjustment changes to be negative could result in the sum of these three amounts to produce negative revenue in one period. An example of this would be when there is an increased risk of mortality (e.g. risk of pandemic) in a term assurance portfolio such that it would cause the risk adjustment to significantly increase and its change in the period becoming greater than the other components of insurance revenue.

To illustrate, using a simple scenario:

A term assurance portfolio liability has the following building block components:

- Discounted PV of expected cash flow of CU15,000, with CU1,000 relating to the current period.
- Risk adjustment has been determined at CU100.
- Contractual service margin has been determined at CU3,800, with CU800 to be recognised in profit or loss for the period.
- A pandemic risk emerges during the period resulting in a level of increased uncertainty causing the risk adjustment to increase by CU2,000.

Analysis

Based on these changes, the 2013 ED requires the insurance revenue to include CU1,000 of expected outflows plus CU800 of released CSM minus changes in the risk adjustment for CU2,000. This produces a negative revenue in the period of CU200.

In parallel with the revenue recognition standard, the trigger for recognising revenue is when a performance obligation or service has been provided or transferred to the customer. The use of this "expected cost plus margins" approach is what the 2013 ED proposes to align insurance revenue to other transactions. This is clearly very different from how insurers currently present revenue which is based on the premiums due when the contracts are initially underwritten ("premiums written").

In parallel with the revenue standard, the trigger for recognising revenue is when a performance obligation or service has been transferred to the customer.

It would appear that the insurance revenue as defined in the 2013 ED depends extensively on the pattern of release of expected outflows that is implicit in the calculations required by the BBA. For example if a contract is expected to have its outflows to be released towards the back end of the coverage period, the revenue profile for that contract is likely to be producing more revenue towards the later years of coverage. This would not necessarily translate in a different profit profile given that the release of the CSM is driven by a more comprehensive assessment of the transfer of services that are provided under the contract (see paragraph 32 of the 2013 ED). As noted earlier, the 2013 ED clearly states that the new revenue amount is not changing the profit calculated under the BBA. Instead, it would only decompose the resulting movement in the liability to present revenue and expenses in the period.

The second requirement to achieve the objective of an insurance revenue amount comparable with IFRS requirements for other transactions is that any deposit components paid during the period are excluded from the expected cash outflows amount. The 2013 ED in paragraph B90 (a) explains that insurance revenue includes "the latest estimates of the expected claims and expenses relating to coverage for the current period excluding those recognised immediately in profit or loss in accordance with paragraphs 60(a) and 60(d). That amount relates to the latest estimates of the expected claims and expenses before the claim is incurred and excludes any repayments of investment components that are included in the latest estimates of the expected claims."

A third requirement comes from the references to paragraph 60(a) and 60(d) above. They relate respectively to the expected cash flows associated with portfolios of contracts that are estimated to be onerous at inception and with the changes in estimates of future cash flows that do not adjust the CSM. With regards to the "day one loss" portfolios the 2013 ED requires that an insurer separates from the liability calculated under the BBA the portion of expected cash flows that trigger the onerous contract status and exclude them from the computation of insurance revenue when they are due to be released in the relevant current period. The identification of these expected cash flows is likely to be resolved via apportionment of the cash flows to a "break even" level (e.g. an "onerous contract" would not be in that state if only 80% of the expected cash flows were included in the BBA liability) with the input to the revenue calculation using that apportionment factor. The principle behind this requirement is that these additional outflows are not covered by any premium and therefore must never feature as revenue for the insurer. This principle applies also to paragraph 60(d) which requires the insurer to isolate any changes in the liability from the BBA that has already been charged through profit or loss because it was excluded from the unlocking of the CSM. An example of these changes is the change in participating contracts liabilities arising from options and guarantees.

As explained above in the 'mirroring approach' section, the measurement of cash flows that vary indirectly with the underlying items are measured using the BBA and they are always accounted for through profit or loss.

The fourth requirement is that an insurer will have to present as an expense the allocation of the acquisition costs that were included as contractual cash flows in the measurement of the insurance contract. The allocation is carried out using the same basis utilised to allocate the CSM to the period. In other words the amount of CSM changes included in the insurance revenue figure is "grossed up" to allow the presentation of an acquisition cost amortisation expense. This requirement follows the decision for the new IFRS on revenue from contracts with customers where it is stipulated that all entities would have to capitalise and amortise directly attributable acquisition costs that have incurred to secure that contract.

The proposals for the new insurance revenue would exclude from its calculation any changes of the LfIC. In many instances the distinction between these two liabilities is straightforward because the liability for incurred claims is settled so quickly that it is safe for an insurer that the entire BBA liability relates to the LfRC. In some instances this would be more complex. For example insurance contracts that cover individuals from disability up to their retirement age may have instances where the policyholder is at the same time covered for future periods and receiving compensation for a past claim. In these instances the 2013 ED would require the split of the total liability, including the apportionment of the risk adjustment liability. The whole CSM liability remains associated with the LfRC given the principle that coverage rather than claims handling is the service the policyholder has purchased.

Finally, the 2013 ED requires new disclosures to be produced to support the insurance revenue. These include the following:

- Paragraph 74 requires a reconciliation in tabular format of the insurance contracts opening and closing balances for the following three components of the insurance liability:
  - LfRC, excluding the amounts included in the liabilities below;
  - LfRC that are attributable to amounts immediately recognised in profit or loss (see discussion on paragraph 60(a) above); and
  - LfIC.

All these tabular reconciliations would need to be prepared separately for insurance contracts issued and for reinsurance contracts held (paragraph 75 stipulates similar requirements for reinsurance contracts held).

- For each of the reconciliations discussed above, paragraph 78 requires that the table includes, among others, amounts that presents the premiums received (or paid for reinsurance contracts), the claims paid (or recovery received for reinsurance contracts) and those amounts recognised in profit or loss as required by paragraph 60 (e.g. those discussed above under 60 (a) and60 (d)).
- A reconciliation to explain the difference between the insurance revenue and the premium received in the period (paragraph 79).
- A complete reconciliation of the insurance revenue calculation (paragraph 81 (a)). This requires the disclosure of the inputs that are used when determining the insurance contract revenue that is recognised in the period:

  i. the expected cash outflows for the period, excluding investment components;

  ii. the acquisition costs that are allocated to the period;

  iii. the change in risk adjustment in the period; and

  iv. the amount of the contractual service margin recognised in the period.

Conclusion

The release of the 2013 ED marks a substantial step ahead in the development of the new IFRS for Insurance Contracts. The changes that are exposed for comments are all the direct result of the IASB making an effort to understand the concerns that both preparers and users of financial statements have identified in the 2010 ED. One of the consequences of this investment in producing a new IFRS that meets as many stakeholders' needs as possible is the extension of the project timeline which has been delayed by several months to complete outreach programmes. Obviously the IASB has not operated these changes in isolation and the constant reference to delivering a faithful representation of the performance of the insurance contract which reflects the economic position of the contract over its life remained a key yardstick. In particular, the continuous reference to the new IFRS on Revenue from Customer Contracts has influenced the unlocking of the CSM and the presentation of insurance revenue. The very material issue of the accounting mismatch between assets and liabilities and the long-term nature of insurance contracts informed the proposals on the presentation of changes in current discount rates through OCI and the development of the 'mirroring approach'.

At the same time as the IASB nearly reaches the final stage in its process the FASB has published its first exposure draft for a brand new US GAAP pronouncement. Although it is not aligned to the IASB proposals in a few material issues, the FASB model presents extensive similarities to the 2013 ED and when measured against the current accounting practices in IFRS and US GAAP for insurance contracts it would appear to have contributed towards convergence.

The new transition requirements are substantially identical between the two proposals and they appear to provide pragmatic guidance which has been unanimously approved by the IASB and FASB. This fact may suggest that it may be unlikely to see them revised.

In parallel with the comment period, the IASB has launched on 2 July 2013 a new round of field testing activities that should help the IASB achieve three specific objectives:

- understand how the revised proposals would operate in practice;
- assess the cost and operational challenges associated with the revised proposals compared to the original proposals in the 2010 ED; and
- assess how the revised proposals will help entities that issue insurance contracts to communicate with users of their financial statements.

The IASB has been liaising with several national standard setters to coordinate field testing activities with them if they were also interested in assessing the impact of the new insurance contract accounting requirements.

Finally, the IASB has also announced that they will conduct extensive outreach activities between September and November this year to hear directly from stakeholders around the world on their views on the 2013 ED. The programme is in progress with dates and venues expected to be confirmed in Europe, Africa, Americas and Asia-Oceania.

Deloitte Insurance contacts

Global insurance network

Neal Baumann
Global Insurance Leader
U.S.
+1 212 618 4105
nealbaumann@deloitte.com

Francesco Nagari
Global IFRS Insurance Leader
U.K.
+44 20 7303 8375
fnagari@deloitte.co.uk

Asia Pacific

Kumiko Aso
Japan
+81 90 3910 2898
kumiko.aso@tohmatsu.co.jp

Terry Mezger
Hong Kong
+852 2238 7264
tmezger@deloitte.com.hk

Simon Walpole
Hong Kong
+852 2238 7229
siwalpole@deloitte.com.hk

EMEA

Fabien Sauvage
France
+33 1 55 61 41 63
fsauvage@deloitte.fr

James O'Riordan
U.K.
+44 20 7007 4933
joriordan@deloitte.co.uk

Andrew Gallacher
Switzerland
+41 58 279 68 90
AGallacher@deloitte.ch

Peter Wright
Czech Republic
+420 246 042 888
pewright@deloittece.com

Latin America

Javier Vazquez
Mexico
+52 555 080 6091
javazquez@deloittemx.com

Carlos Srulevich
Argentina
+54 11 43202734
csrulevich@deloitte.com

North America

Gary Shaw
U.S.
+1 973 602 6659
gashaw@deloitte.com

Rajiv Basu
U.S.
+1 212 436 4808
rbasu@deloitte.com

Daniel Shum
Canada
+1 416 874 4248
DaShum@deloitte.ca

Neil Harrison
Canada
+1 416 601 6307
nharrison@deloitte.ca

John Johnston
Bermuda
+441 292 1301
john.johnston@deloitte.bm

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