Australian Government
Australian Accounting Standards Board

Staff Paper

Purpose of this paper

1 This paper highlights key issues from the IASB's ED/2013/7 *Insurance Contracts* on which the AASB commented.

2 The AASB had mixed success on the issues raised, including:

(a) making comments that helped influence the IASB to improve the proposals [issues 1(b) and 3 in the table below];

(b) raising issues that the IASB did not act on [issues 1(a), 7(a) and 7(b) in the table below]; and

(c) supported positions in ED/2013/7 that the IASB subsequently revised in a retrograde way [issues 1(c) and 2 in the table below].

Colour coding

3 The issues are 'colour-coded', with:

* red denoting remaining issues of key concern;
* green denoting issues on which the IASB responded favourably to AASB comments; and
* orange denoting issues of concern that are regarded as manageable or may be at least partially resolved in the drafting process.

Question for Board members

Q1 Based on the information presented in the table below and the discussions in the meeting, what other information does the Board wish to have in the lead up to finalising a revised AASB 4 *Insurance Contracts*?

Summary of IASB ED/2013/7 *Insurance Contracts* Proposals, the AASB's Comments on the ED and the IASB's Subsequent Decisions

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
1(a). Accounting for the contractual service margin (CSM) – Discount rates			
Paragraphs 25 to 27 propose that an entity determines the fulfilment cash flows by adjusting the estimates of future cash flows for the time value of money, using discount rates that reflect the characteristics of those cash flows. The discount rate at the inception of the contract is applied in accounting for the CSM. Paragraphs B69 to B70 propose that the discount rate used to adjust the cash flows in an insurance contract should be consistent with current observable market prices of instruments with similar cash flows. An entity adjusts those prices to reflect the differences between those cash flows and the cash flows of the insurance contract in terms of timing, currency and liquidity. The entity includes in the discount rates for the insurance contract only those factors that are relevant for the insurance contract.	The AASB supports the IASB's proposals to discount estimates of fulfilment cash flows. However, the AASB expressed strong concerns about developing an essentially current measurement value model, but keeping one historical cost element (the discount rate) for the CSM. The AASB noted that this would: (1) result in different accounting for similar contracts depending on when they incepted and be a source of confusion for users; and (2) involve considerable costs in identifying and tracking discount rates from contract inception for the life of a contract. Presumably, the unit of account will need to be either each contract or a portfolio of similar contracts determined by when the discount rate changes in a manner that would have a material impact, which could be many times within a reporting period.	The IASB tentatively decided that, for contracts without participating features, an entity should use the locked-in rate at the inception of the contract for accreting interest on the contractual service margin and for calculating the change in present value of expected cash flows that offsets that margin. The IASB also tentatively decided not to require or permit in the general model the remeasurement of the CSM using current discount rates. For participating contracts accounted for using the variable fee model, the CSM is accounted for using current discount rates because the policyholders are taken to be participating in the current underlying investment performance.	The IASB's subsequent decision on the general model is not consistent with the AASB's comments. The AASB has made multiple (unsuccessful) attempts to have the IASB change its mind (including with the NZASB at the July 2015 ASAF meeting) and require (or permit) the use of current discount rates in accounting for the CSM under the general model when the entity uses the option to present the impact of discount rate changes in income. Under the simplified model (essentially, for contracts with a coverage period of a year or less), claims liabilities are discounted using current rates. It remains unclear how using inception-date discount rates will affect the units of account insurers will need to apply. This is something AASB staff will seek to have clarified at the IFRS drafting stage.

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
1(b). Accounting for the CSM – Cash flows			
Paragraphs 30-31 propose that, unless the simplified approach is used, the CSM is adjusted for differences between the current and previous estimates of the present value of future cash flows that relate to future coverage and other future services, provided the CSM would not be negative.	In response to ED/2010/8, which proposed that the CSM (then regarded as a residual) would not be adjusted for changed estimates of cash flows in respect of future coverage, the AASB had advocated for the position in ED/2013/7. Accordingly, the AASB supported the proposal that the CSM be adjusted and that the CSM cannot be negative (paragraph 30) and any further projected deterioration is recognised immediately in income (paragraph 31). However, the AASB recommended that the IASB also address accounting for the reversal of circumstances that gave rise to losses. The AASB would expect this to involve reversing the effects of previous loss recognition, which (depending on the extent of subsequent improvements in expected cash flows related to future coverage) could involve recognising gains in income and 'rebuilding' the CSM.	The IASB tentatively decided to confirm that, for the general model, the CSM should be adjusted for differences between the current and previous estimates of the present value of future cash flows that relate to future coverage and other future services, provided that the CSM would not be negative. The IASB tentatively decided that favourable changes in estimates (that arise after losses were previously recognised in income) should be recognised in income to the extent they reverse losses relating to coverage and other services in the future.	The IASB's subsequent decision is consistent with the AASB's comments. However, the CSM treatment is not entirely clear in view of the IASB's decision on the pattern of CSM recognition [issue 1(c)]. This is something AASB staff will seek to have clarified at the IFRS drafting stage.

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
1(c). Accounting for the CSM – Pattern of recognition			
Paragraph 32 proposes that an entity recognises the remaining CSM over the coverage period in the systematic way that best reflects the remaining transfer of services that are provided under the contract.	The AASB agreed with the proposal and did not comment in its submission on ED/2013/7.	The IASB tentatively decided to confirm the paragraph 32 proposal and also "clarified" that for all insurance contracts, including those with participation features, an entity would recognise the CSM in income on the basis of the passage of time, allowing for lapsed contracts. The IASB has made it clear that this effectively means the CSM is recognised evenly over the coverage period (absent changes in estimation of cash flows relating future coverage). The IASB sees this as a simplification and anti-abuse requirement.	In the July 2015 ASAF papers, the AASB/NZASB recommended that the CSM under the general approach is recognised in income on the basis of the passage of time, but if the expected pattern of services differs significantly from the passage of time, then on the basis of expected timing of services. This would make it comparable with the simplified model. The AASB/NZASB also noted the expected timing of services can significantly differ from using passage of time alone if the level of settlement or lapse of contracts has a material impact. The AASB/NZASB are concerned that, for some types of contracts, profit recognition could be artificially delayed or advanced by applying passage of time alone for CSM recognition. For particular products, such as lenders' mortgage insurance and bundled investment-insurance contacts, this may provide a distorted pattern of profit recognition relative to the services provided by insurers that will further complicate the work of financial statement users.

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
2. Unit of account and onerous contracts			
Paragraph 15 proposes that an entity needs to assess whether a contract is onerous when facts and circumstances indicate that the portfolio of contracts will contain the contract is onerous. A portfolio of insurance contracts is onerous if the sum of the fulfilment cash flows and any pre-coverage cash flows is greater than zero. Paragraph 36 proposed that when an entity simplifies the measurement of the liability for the remaining coverage in accordance with paragraphs 38–40, it recognises an onerous contract liability if, at initial recognition or subsequently, facts and circumstances indicate that the portfolio of insurance contracts containing the contract is onerous.	The IASB did not seek comments on this aspect of ED/2013/7. The AASB did not comment in its submission on ED/2013/7.	The IASB tentatively decided losses for onerous contracts would be recognised only when the CSM is negative for a group of contracts. The group should comprise contracts that at inception have cash flows the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing; and had similar expected profitability (similar CSM as a % of premium). The IASB also tentatively decided there should be no exception to the level of aggregation for determining onerous contracts (or allocation of CSM) when regulation affects the pricing of contracts. The IASB's discussion of the impact of regulation on onerous contract assessments helped reveal an indication of the granularity of the units of account the IASB might be expecting. However, this will probably not be clear until the draft IFRS is available.	The feedback from the AASB February 2016 Insurance Project Advisory Panel meeting, and the subsequence March 2016 AASB staff paper to the IASB staff, expressed concern that the level of contract aggregation could vary considerably depending on the information available from policyholders. The comparability between the reported results of entities will be reduced when they have different information available to them. The concern of the AASB Insurance Project Advisory Panel is also that a level of granularity different from the level at which premiums are set will add to user's difficulties in analysing insurers' financial statements. This is because the management of the business will be at the portfolio pricing level while the more granular accounting will tend to shift losses to earlier periods, which may require entities to provide further explanation of their results. AASB staff will seek to have unit of account issues clarified at the IFRS drafting stage.

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
3. Mirror accounting for contracts with underlying items			
Paragraphs 33 and 34 propose an entity determines whether the contract specifies a link to returns on underlying items by considering all the substantive terms of the contract, whether they arise from a contract, the law or regulation. The entity subsequently measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items. The fulfilment cash flows that are not expected to vary directly with returns on underlying items would have the 'normal' requirement (paragraphs 18 to 27) applied to them. Paragraph 66 also proposes mirror accounting for changes in fulfilment cash flows that are expected to vary directly with returns on underlying items.	The AASB expected that significant operational complexities are likely to exist in respect of applying mirror accounting and the cost of mandatory mirror accounting as proposed would outweigh the benefits. By definition, the contracts to which mirroring would have applied are those for which it is impracticable to unbundle the components. However, there would be a need to unbundle to determine the part of the contract to which mirroring should apply. The AASB suggested that mirror accounting could be mandated for relatively simple investment-linked insurance contracts or the components of contracts that are clearly investment-linked.	The IASB tentatively decided that the mirroring approach proposed in paragraphs 33-34 of ED/2013/7 should not be permitted or required. Instead, the IASB has tentatively decided on a 'variable fee' model. Under the variable fee model, changes in the estimate of fees that the entity expects to earn from the contracts are adjusted in the CSM. This includes the effect of changes in market variables on financial guarantees embedded in insurance contracts. The fees that the entity expects to earn from a portfolio of contracts are equal to the entity's expected share of the returns on underlying items, less any expected cash flows that do not vary directly with the underlying items.	The IASB's subsequent decision on mirror accounting for contracts with underlying items is largely consistent with the AASB's comments. The IASB did not take the AASB's suggestion on mirror accounting for relatively simple investment-linked insurance contracts with cash flows varying directly with the returns on underlying items. While only a few Australian/New Zealand entities have material participating contracts, the impact of the variable fee model may have a significant impact on them, which has not been field tested. AASB staff will seek to help clarify the operation of the variable fee model at the IFRS drafting stage.

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
4. Presentation of insurance contract revenue and expenses			
Paragraphs 56 to 59 propose that an entity presents revenue relating to insurance contracts, incurred claims and other expenses relating to an insurance contract in the statement of comprehensive income. Revenue is to depict the transfer of promised services arising from an insurance contract in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Insurance contract revenue and incurred claims in the statement of comprehensive income is to exclude any investment components that have not been separated (unbundled from insurance contracts).	The AASB supported that, for all insurance contracts, an entity presents insurance contract revenue and expenses (rather than information about the changes in the components of the insurance contracts, as ED/2010/8 proposed) in the income statement. However, the AASB noted that Australian life insurers would be particularly affected by the proposals as they would need to change their systems to recognise only revenue related to risks borne in the period.	The IASB tentatively decided to confirm the ED/2013/7 proposals that an entity should present insurance contract revenue and expense in the statement of comprehensive income. In addition, the IASB tentatively decided that an entity should be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue.	The IASB's subsequent decision (included in ED/2013/7) on presentation of insurance contract revenue and expenses is consistent overall with the AASB's comments. There is an acknowledgement among Australian insurance stakeholders that, although it will require a change to information systems for some types of business, the tentatively decided presentation will be more comparable (than current practice) with income statement presentation in other industries.

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
5. Interest expense in income			
Paragraphs 60 to 65 propose that an entity segregate the effects of underwriting performance from the effects of changes in discount rates. An entity recognises, in income, the interest expense determined using the discount rates that applied at the date the contract was initially recognised (paragraph 61). The entity presents the effect of the changes in the discount rate by recognising, in OCI, the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract measured using the discount rates that applied at the date the contract was initially recognised (Paragraph 62).	The AASB strongly opposed this proposal and suggested the 'default' requirement should be a current measurement basis for insurance liabilities with all changes in the liability being recognised in profit or loss. However, the AASB noted it could support having an option to present the impact of changes in discount rates in OCI that an entity could choose to use for insurance activities on transition to the revised insurance contracts standard.	The IASB tentatively decided that an entity could choose, as its accounting policy, either to disaggregate changes in market variables between profit or loss and OCI using a cost measurement basis and a current measurement basis, or to present the insurance investment expense in profit or loss using a current measurement basis. The policy choice can be made on a portfolio basis, provided portfolios of similar business are treated similarly. The IASB also tentatively decided that, for all insurance contracts, an entity should present changes in estimates of the amount of cash flows that result from changes in market variables in the same location in the statement of comprehensive income consistently with the changes in discount rates.	The IASB's subsequent decision on presenting the effect of changes in the discount rates in either OCI or profit or loss goes some way towards the direction the AASB is advocating. However, the benefit of being able to present the impact of changes in discount rates (and other market variables) in profit or loss might be lost because of the IASB's position on using inception-date discount rates in accounting for the CSM (see issue 1(a) above).

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
6. Disclosure			
Paragraphs 74 to 79 propose a range of reconciliation disclosures.	The AASB noted the requirements for reconciliations in paragraphs 74 to 79 seem particularly burdensome.	The IASB tentatively decided to delete the proposed requirements that an entity should disclose a reconciliation of revenue recognised in income in the period to premiums received in the period (paragraph 79).	The IASB's subsequent decision on disclosure of a reconciliation of the amount to the line items is partially consistent with the AASB's comments. The AASB staff will monitor how the drafting of disclosure requirements progresses – it is not yet clear how the IASB will be addressing disclosures affected by its recent recognition and measurement decisions.
7(a). Separating insurance contracts from investment contracts – Lapse			
Paragraphs B31 to B32 propose that, unless the investment component and insurance component are highly interrelated, an investment contract is distinct if a contract with equivalent terms is sold or could be sold separately in the same market or jurisdiction by the entity or any other entity. Paragraph B32 also notes that, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity must treat the whole contract as an insurance contract.	The AASB noted that Paragraph B32 introduces a proposed rule that overrides the principle. The AASB argued that this condition (lapse or maturity of one component in a contract causes the lapse or maturity of the other) should only be an indicator helping elucidate the principle.	No action being taken by the IASB.	The IASB's rule-based approach on separating insurance contracts from investment contracts is not consistent with the AASB's comments. The issue may not have a significant impact depending on the requirements around what constitutes a contract. Many recent contracts with investment and insurance components (that are unbundled under existing Australian/New Zealand GAAP) might be considered to comprise two separate contracts (and the unbundled outcome would be achieved in any case).

ED/2013/7 *Insurance Contracts*	AASB Comments	IASB Subsequent Decisions	Comments
7(b). Separating insurance contracts from investment contracts – Locked in classification			
Paragraph B25 proposed a rule that a contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished.	The AASB noted that paragraph B25 has the potential to seriously distort the financial statements of insurers because, for example, contracts that are predominantly insurance by nature at inception can become predominantly investment contracts over the contract term. Current Australian practice is to classify and reclassify contracts and their components based on a current assessment of their nature. Entities that have multiple activities such as banking, wealth management and insurance would be reporting their segments using current information. The distortion might be revealed in a reconciliation to segment disclosures (required by paragraph 28 of AASB 8 *Operating Segments*).	No action being taken by the IASB.	The IASB's rule-based approach is not consistent with the AASB's comments. The impact of this 'rule' will probably depend on other factors, such as what constitutes a contract. AASB staff will seek to help clarify the operation of locked-in classification at the IFRS drafting stage.