

**This Agenda Paper provides a comparison of the candidate liability measurement approaches considered by the IASB in its Insurance Contracts project and the liability measurement approaches under AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*.**

## Background

1. At its April 2009 meeting, IASB Insurance Working Group member Mr Tony Coleman presented to the Board on the liability measurement approaches being considered by the IASB in its Insurance Contracts project. The Board agreed that it should be informed about the potential impact of the IASB's proposals on existing practice in Australia as well as the IASB's research. Accordingly, the Board decided that staff should prepare an agenda paper for a future meeting which compares these liability measurement approaches with the liability measurement approaches under AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*. At its April 2009 meeting, the Board also agreed that it should consider providing input on selected insurance issues in advance of the IASB's forthcoming ED on insurance contracts. The IASB is currently working towards publishing an ED on insurance contracts in the last quarter of 2009.
2. To facilitate the Board's discussion, this Paper uses a similar format to that used by Mr Coleman in his presentation to the Board.
3. An insurance contract, particularly a general insurance contract, is often thought of as giving rise to two types of liabilities: a pre-claims liability (stand ready obligation) to meet claims over the remaining periods of existing contracts and a claims liability in respect of any claims that have been incurred in relation to existing contracts but not yet paid. Apart from an unearned premium model, each of the candidate liability measurement approaches considered by the IASB would be expected to be able to be applied to both types of insurance liabilities.
4. It is relevant to note that the approach under IFRS 4/AASB 4 *Insurance Contracts* is not separately considered in this Paper because:
  - (a) from the IASB's perspective, the approach under IFRS 4 is essentially a vehicle for grandfathering national practices that existed before IFRSs were adopted, while the IASB works on the current phase of its Insurance Contracts project;
  - (b) in contrast to the main liability measurement approaches currently being considered by the IASB and the approaches under AASB 1023 and AASB 1038, IFRS 4 does not provide any requirements or guidance on discount rates and margins that would need to be considered in determining an insurance liability; and
  - (c) relevant features of IFRS 4 have been included in AASB 1023 and AASB 1038.

## Insurance liability measurement approaches

5. The following tables provide a comparison of the measurement objectives, main characteristics and implications of each of the candidate liability measurement approaches that the IASB has considered to date as a part of its Insurance Contracts project, and the liability measurement approaches under AASB 1023 and AASB 1038. It is relevant to note that:
  - (a) the IASB has recently narrowed the field of likely measurement candidates to:

- (i) a measurement approach based on the measurement approach being developed in the project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* ('Approach based on updated IAS 37'); and
  - (ii) a current fulfilment value that includes a composite margin ['Entry value (candidate 4)'];
- (b) at its July 2009 meeting, the IASB tentatively decided that:
- (i) an unearned premium approach would provide decision-useful information about pre-claims liabilities of short duration insurance contracts; and
  - (ii) to require rather than permit the use of an unearned premium approach for those liabilities.

However, based on the IASB's decisions at this meeting, it is likely that the unearned premium approach would only be used where it is considered to be a simplified version of the principal liability measurement approach applicable to all insurance contracts;

- (c) some of the liability measurement approaches under consideration by the IASB share characteristics with the AASB 1023 and AASB 1038 models; and
- (d) the IASB's deliberations have tended to focus on particular characteristics and components of each of the candidate liability measurement approaches rather than each individual approach as a whole. In addition, the IASB's deliberations on the implications of some of the candidates are more advanced (for instance, current exit value) than its deliberations on other candidates (for instance, an approach based on an updated IAS 37 model). Accordingly, the following tables provide most, but not all, of the implications of all of the liability measurement approaches considered by the IASB as a part of its Insurance Contracts project.

Table 1 – Liability Measurement Objectives

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
The amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity (including a risk margin and, if applicable, a service margin) <b>plus</b> a <i>residual margin</i> for any difference between the premium and the current exit value at inception.	The expected present value of the cost to the entity of fulfilling the obligation to the policyholder over time (including a <i>risk margin</i> only).	The expected present value of the cost to the entity of fulfilling the obligation to the policyholder over time (including a <i>risk margin</i> ) <b>plus</b> a <i>residual margin</i> for any difference between the premium and the current fulfilment value at inception.	The expected present value of the cost to the entity of fulfilling the obligation to the policyholder over time (excluding a risk margin) <b>plus</b> a <i>composite margin</i> calibrated at inception to the premium (including a risk margin and, if applicable, a service margin and any other margins).	The part of the premiums for the unexpired part of the insurer's contractual obligation ( <i>original transaction price or cost</i> ), subject to a liability adequacy test (LAT) (under which the liability would be measured in accordance with the principal liability measurement approach).	The amount the insurer would rationally pay at the end of the reporting period to be relieved of its present obligations under an insurance contract [i.e., the lowest of: (a) the value to the entity of not having to fulfil the liability; (b) the price the market would demand to assume the liability; and (c) the price that the counterparty would demand to commute the liability, if commutation is possible] <b>plus</b> a <i>residual margin</i> for any difference between the premium and the obligation value at inception.	An estimate of the expected present value of future payments in respect of: (a) the unexpired part of the insurer's contractual obligation or deferred premiums relating to that period ('pre-claims liability') ( <i>original transaction price or cost</i> ), subject to a LAT ( <i>current fulfilment value</i> ) and (b) incurred claims liability, which is calculated on the basis of a central estimate of the expected future payments <b>plus</b> a <i>risk margin</i> ( <i>current fulfilment value</i> ).	An estimate of the present value of the expected future receipts from, and payments to, policyholders, including participating benefits, plus the <i>planned margins of revenues over expenses</i> relating to services yet to be provided to policyholders <b>or</b> (if it would give rise to a similar outcome) the accumulated benefits to policyholders after allowing for the relevant portion of recoupable acquisition costs. In addition, both measurements are subject to a LAT ( <i>current fulfilment value</i> ).

**Table 2 – Liability Measurement Characteristics – Scope and Building Blocks**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
<i>Scope</i>							
All insurance liabilities	All insurance liabilities	All insurance liabilities	All insurance liabilities	Generally only applicable to the pre-claims liabilities of short duration insurance contracts.	All insurance liabilities.	General insurance contracts (including reinsurance contracts).	Life insurance contracts (including reinsurance contracts).
<i>Building blocks</i>							
- explicit unbiased estimate of the expected (probability weighted) future cash flows that a market participant would expect to incur to fulfil the contractual obligations to the policyholder over time - time value of money - an explicit margin	- explicit unbiased estimate of the expected (probability weighted) future cash flows necessary for the insurer to fulfil its contractual obligations to the policyholder over time - time value of money - an explicit margin	- explicit unbiased estimate of the expected (probability weighted) future cash flows necessary for the insurer to fulfil its contractual obligations to the policyholder over time - time value of money - an explicit margin	- explicit unbiased estimate of the expected (probability weighted) future cash flows necessary for the insurer to fulfil its contractual obligations to the policyholder over time - time value of money - an explicit margin	An implicit building blocks approach that includes: - expected cash flows; - time value of money; and - a margin; as implied by the premiums received.	A building blocks approach [including: (a) current estimate of the expected (probability weighted) present value of future cash flows; (b) time value of money; and (c) an explicit margin] <b>unless</b> the insurer has objective evidence that it can transfer or settle the liability.	An implicit building blocks approach in respect of any unearned premium and an explicit building blocks approach in respect of incurred claims that includes: (a) expected cash flows; (b) time value of money; and (c) a margin.	- unbiased estimate of expected future cash flows - time value of money - an explicit margin

**Table 3 – Liability Measurement Components – Inputs for Estimates of Cash Flows**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
<i>Inputs for which observable market information is available (financial market variables)</i>							
Consistent with observed market inputs.	Consistent with observed market inputs.	Consistent with observed market inputs.	Consistent with observed market inputs.	Not applicable unless a LAT is applied because contracts have become onerous, in which case inputs are consistent with observed market inputs.	Consistent with observed market inputs.	<b>Pre-claims liability:</b> not applicable unless LAT is applied when contracts become onerous, in which case inputs are consistent with observed market prices. <b>Incurred claims liability:</b> consistent with observed market inputs.	Consistent with observed market inputs.
<i>Other inputs</i>							
Estimates should be consistent with those of market participants. Accordingly, estimates based on the entity's own inputs would be excluded.	The entity's estimate of the cash flows it would incur in fulfilling its obligation to a policyholder (e.g., claims handling expenses and administration costs).	The entity's estimate of the cash flows it would incur in fulfilling its obligation to a policyholder (e.g., claims handling expenses and administration costs).	The entity's estimate of the cash flows it would incur in fulfilling its obligation to a policyholder (e.g., claims handling expenses and administration costs).	Not applicable unless a LAT is applied because contracts become onerous, in which case inputs would be determined consistent with the measurement approach applied.	The entity's estimate of the cash flows it would incur in fulfilling its obligation to a policyholder except in relation to other services (although this may need to be estimated based on the amount the insurer requires for such services).	<b>Pre-claims liability:</b> Not applicable unless a LAT is applied when contracts become onerous, in which case such inputs are consistent with observed market inputs. <b>Incurred claims liability:</b> Consistent with observed market inputs.	When observable market information is unavailable, inputs are based on the entity's own estimates.

**Table 4 – Liability Measurement Components – Characteristics of Cash Flows and Subsequent Measurement**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
<i>Characteristics of cash flows – inclusion of portfolio-specific cash flows</i>							
Included.	Included.	Included.	Included.	Not included unless LAT is applied.	Included.	<i>Pre-claims liability:</i> not included unless a LAT is applied (see para. 5.1.9). <i>Claims liability:</i> included.	Included.
<i>Subsequent measurement of cash flows</i>							
Current estimates for all variables.	Current estimates for all variables.	Current estimates for all variables.	Current estimates for all variables.	No remeasurement unless LAT is applied, in which case current estimates for all variables.	Current estimates for all variables and changes included in profit or loss (P/L).	<i>Pre-claims liability:</i> no remeasurement unless LAT is applied, in which case current estimates for all variables. <i>Claims liability:</i> current estimates for all variables.	Current estimates for all variables.
<i>Treatment of any remeasurement changes in estimated cash flows</i>							
Included in P/L in the period in which the change occurs.	Included in P/L in the period in which the change occurs.	Included in P/L in the period in which the change occurs.	Included in P/L in the period in which the change occurs.	No remeasurement unless LAT is applied, in which case included in P/L in the period in which the change occurs.	Included in P/L in the period in which the change occurs.	Included in P/L in the period in which the change occurs.	Differences between assumed and actual cash flows are included in P/L in the period in which the change occurs. The impact of changes in assumptions made during the period are spread over the remaining contract periods (by adjusting planned margins), except for changes in: (a) estimated present value of expenses over revenues; (b) any subsequent reversal of (a); and (c) discount rates and related economic assumptions; which are included in P/L when they occur.

**Table 5 – Liability Measurement Components – Discount Rates**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
Current market discount rates that are consistent with observable market prices, capture the characteristics of the liability, and adjust cash flows for the time value of money.	Current market discount rates that are consistent with observable market prices, capture the characteristics of the liability, and adjust cash flows for the time value of money.	Current market discount rates that are consistent with observable market prices, capture the characteristics of the liability, and adjust cash flows for the time value of money.	Current market discount rates that are consistent with observable market prices, capture the characteristics of the liability, and adjust cash flows for the time value of money.	<p>If LAT has not been applied, the obligation has been implicitly discounted as the premium will reflect the insurer’s expected rate of return on the assets backing the obligation.</p> <p>If LAT has been applied, the obligation is explicitly discounted at current market discount rates that adjust the cash flows for the time value of money.</p>	Current market discount rates that are consistent with observable market prices, capture the characteristics of the liability, and adjust cash flows for the time value of money.	<p><b>Pre-claims liability:</b> if LAT has not been applied, the obligation has been implicitly discounted as the premium will reflect the insurer’s expected rate of return on the assets backing the obligation. If LAT has been applied, the obligation is explicitly discounted at current market discount rates that adjust the cash flows for the time value of money.</p> <p><b>Claims liability:</b> discounted at a risk-free discount rate based on current observable, objective rates that relate to the nature, structure and term of the future obligations.</p>	A risk-free discount rate based on current observable, objective rates that relate to the nature, structure and term of the future obligations, unless the benefits are contractually linked to the performance of the assets held, in which case the discount rate is based on market returns on the assets backing life insurance liabilities.

**Table 6 – Liability Measurement Components – Margins**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
A <i>risk margin</i> which reflects an estimate of the compensation that market participants would require for bearing risk <b>and</b> , if applicable, a <i>service margin</i> which reflects the compensation to market participants for providing other services <b>and</b> a residual margin for the difference between the premium and the current exit value of the contract plus risk and service margins at inception.	A <i>risk margin</i> that reflects the cost/compensation to the insurer of bearing the risks associated with insurance contracts, including mortality and operational risks. No service margin is included because any margin above the risk margin is not considered to be part of the fulfilment costs arising from insurance contracts.	A <i>risk margin</i> that reflects the cost/compensation to the insurer of bearing the risks associated with insurance contracts <b>and</b> a <i>residual margin</i> equal to the difference between the premium and the current fulfilment value plus the risk margin at inception.	A <i>composite margin</i> , which would include an implicit risk margin and, if applicable, an implicit service margin, which is set at inception of the contract to the premium.	No explicit margin required. Implicit margin set at inception of the contract, as implied by the premium.	A <i>risk margin</i> that reflects the amount that the insurer would pay to be relieved of the risk in the expected cash flows <b>and</b> , if applicable, a <i>service margin</i> which reflects the compensation a contractor (or the insurer) would require to provide the services (depending upon whether there is an efficient market for such services) <b>and</b> a <i>residual margin</i> for any difference between the premium and the obligation value plus risk and service margins at inception.	<b>Pre-claims liability:</b> no explicit margin required in respect of unearned premiums. Implicit margin set at inception of the contract, as implied by the premium. If LAT has been applied, a <i>risk margin</i> to reflect inherent uncertainty in the central estimate of the present value of the expected future payments is included.  <b>Claims liability:</b> a <i>risk margin</i> to reflect the inherent uncertainty in the central estimate is included. The risk margin is determined by class of business, and may be adjusted to reflect diversification between classes.	<i>Planned margins of revenues over expenses</i> relating to services yet to be provided to policyholders, including a risk margin, a service margin and other margins such as selling margin and recovery of acquisition costs.

Table 7 – Liability Measurement Implications – Remeasurement of Margins

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
<p>The <i>risk margin</i> and any <i>service margin</i> would be remeasured at each reporting date, based on what a market participant would require for the remaining risk and services, and any remeasurement change recognised in P/L.</p> <p>The <i>risk and service margins</i> would also be released to P/L as the insurer is released from risk and performs services respectively.</p>	<p>The <i>risk margin</i> would be remeasured at each reporting date and any remeasurement change recognised in P/L. The <i>risk margin</i> would also be released to P/L as the insurer is released from risk.</p>	<p>The <i>risk margin</i> would be remeasured at each reporting date, based on the updated cost of bearing risk, and any remeasurement change recognised in P/L. The <i>risk margin</i> would also be released to P/L as the insurer is released from risk.</p>	<p>The <i>composite margin</i> would be locked in at inception and released to P/L over time in accordance with an appropriate driver, such as risk.</p>	<p>An unearned premium liability would implicitly include a <i>composite margin</i>, but the margin would not be separately measured from the unearned premium. The implicit <i>composite margin</i> would be released to the P/L over time as the premium becomes earned in accordance with an appropriate driver.</p>	<p>The <i>risk margin</i> and any <i>service margin</i> would be remeasured at each reporting date and remeasurement changes recognised in P/L. The <i>risk and service margins</i> would also be released to P/L as the insurer is released from risk and performs services respectively.</p>	<p><b>Pre-claims liability:</b> unearned premium liability would implicitly include a <i>composite margin</i> that would be released to the P/L as the insurer is released from risk. The implicit <i>composite margin</i> in unearned premium would also presumably be remeasured when a LAT is applied.</p> <p><b>Claims liability:</b> includes a <i>risk margin</i> that would be remeasured at each reporting date, based on the inherent uncertainty in the central estimate. All remeasurement changes would be recognised in P/L. The <i>risk margin</i> would also be released to P/L as the insurer is released from risk.</p> <p>It is relevant to note that APRA requires Australian insurers to estimate uncertainty in terms of the 75<sup>th</sup> percentile, and half the coefficient of variation, of net insurance liabilities ('probability of adequacy'), including the risk of reinsurance.</p>	<p><i>Planned margins of revenues over expenses</i> are locked in at inception, released over time to P/L in accordance with an appropriate driver and only remeasured when a LAT determines that the present value of future expenses exceeds the present value of future revenues. All remeasurement changes would be recognised in P/L.</p>

**Table 8 – Liability Measurement Implications – Liability Adequacy Test and ‘Day-One’ Differences<sup>1</sup>**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
<i>Liability adequacy test applicable?</i>							
No.	No.	No.	May be applicable at inception if the premium is insufficient to cover the obligation. Subsequent to inception, no LAT is required.	Applicable when the present value of the expected future cash flows in respect to policyholders is greater than the amount of unearned premium revenues.	No.	Applicable when the present value of expected future cash flows for future claims for the period of unexpired risk under current contracts exceeds the unearned premium liability.	Applicable when the present value of estimated future expenses exceeds the present value of estimated future revenues for a group of related products.
<i>Day-one differences?</i>							
Would not arise because of the inclusion of a residual margin. However, in the absence of the residual margin, day-one differences might be relatively common as a result of, for instance, premiums being set to recover direct and indirect origination costs that a market participant would not have to incur.	Would potentially arise because the liability excludes all margins other than a risk margin. Accordingly, if the premium is set to include a service margin, a day-one gain would arise.	Would not arise because the residual margin is calibrated to the premium at inception.	Would not arise because the composite margin is calibrated to the premium at inception.	Day-one gains would not arise because the deferred premium liability is set at the amount of the premium at inception. Day-one losses might arise at inception if a LAT is applied.	Day one gains would not arise because the residual margin is calibrated to the premium at inception. Day-one losses might arise at inception if the contract is onerous.	Day-one gains do not arise because the deferred premium liability is set at the amount of the premium at inception. Day-one losses might arise at inception if a LAT is applied.	Day-one gains do not arise because planned margins of revenues over expenses are calibrated to the premium at inception. Day-one losses might arise at inception if a LAT is applied.

<sup>1</sup> The IASB has concluded that a day-one difference would arise when the premium less incremental acquisition costs on inception differs from the amount of the insurance obligation recognised by the insurer on inception. Accordingly, a day-one difference arises when the required and actual margins on inception differ.

**Table 9 – Liability Measurement Implications – Treatment of Incremental Acquisition Costs and Part of the Premium Expected to Recover Incremental Acquisition Costs**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
<i>Treatment of acquisition costs</i>							
Expense when incurred.	Expense when incurred.	Expense when incurred.	Expense when incurred.	Expense when incurred.	Expense when incurred.	Defer and recognise as assets where they can be reliably measured and will give rise to premium revenue that will be recognised in P/L in subsequent periods.	Expense when incurred.
<i>Treatment of part of the premium expected to recover incremental acquisition costs</i>							
Recognise as revenue on day one.	Recognise as revenue on day one.	Recognise as revenue on day one.	Recognise as revenue on day one.	Recognise as revenue on day one.	Recognise as revenue on day one.	Recognise as revenue over the period of the contract in accordance with an appropriate driver, such as risk.	Recognise as revenue on day one.

**Table 10 – Liability Measurement Implications – Own Credit Risk**

IASB Candidates						Australian Accounting Standards	
Current exit value (candidate 1)	Current fulfilment value (candidate 2)	Current fulfilment value (candidate 3)	Entry value (candidate 4)	Unearned premium (candidate 5)	Approach based on updated IAS 37	AASB 1023	AASB 1038
Included in both initial and subsequent measurement.	Not yet considered by the IASB but arguably implicitly included in the premium amount at inception and therefore reflected in any day-one difference.	Not yet considered by the IASB but arguably implicitly included in the premium amount and therefore reflected in the residual margin at inception.	Not yet considered by the IASB but arguably implicitly included in the premium amount and therefore reflected in the composite margin at inception.	Not yet considered by the IASB but arguably implicitly included in the premium amount and therefore reflected in the unearned premium liability.	Not yet considered by the IASB but arguably included in the premium amount and therefore reflected in the residual margin at inception.	<i>Pre-claims liability</i> : implicitly included in the premium amount and therefore reflected in the unearned premium liability. <i>Claims liability</i> : not explicitly included.	Not explicitly included but arguably implicitly included in the premium amount and therefore reflected in the planned margins of revenues over expenses at inception.

**How the liability measurement approaches under AASB 1023 and AASB 1038 compare with the IASB's candidate liability measurement approaches**

6. Based upon the comparisons provided in the tables above, staff consider the liability measurement approaches under AASB 1023 and AASB 1038 could be characterised as 'hybrids' of at least two of the liability measurement approaches the IASB has considered to date as a part of its Insurance Contracts project. Specifically, staff consider:
  - (a) the liability measurement approach under AASB 1023 to be a hybrid of:
    - (i) the unearned premium approach in respect of pre-claims liabilities; and
    - (ii) a current fulfilment value approach (candidate 2) in respect of unearned premium that has been remeasured as a consequence of applying a liability adequacy test, and claims liabilities; and
  - (b) the liability measurement approach under AASB 1038 to be a hybrid of:
    - (i) an entry value approach (candidate 4); and
    - (ii) a liability adequacy test (which is a characteristic of an unearned premium approach only).
7. Based on its decisions to date, it appears likely that the IASB will favour a hybrid approach to be applied to all types of insurance contracts that will reflect only some of the elements in AASB 1023 or AASB 1038. This is because the IASB has:
  - (a) tentatively decided that an entity should be required (rather than permitted) to apply an unearned premium approach for pre-claims liabilities of short-duration insurance contracts; and
  - (b) tentatively decided to remove several of the candidate liability measurement approaches, including a current fulfilment value approach (candidate 2) and a current entry value approach (candidate 4), from its list of potential candidates.

**The IASB's preferred candidate liability measurement approaches**

8. At its July 2009 meeting, the IASB considered whether to propose:
  - (a) a measurement approach based on the approach being developed in the project to amend IAS 37; or
  - (b) a current fulfilment value that includes a composite margin [a modified version of current fulfilment value (candidate 3)],as its principal liability measurement approach.
9. There are a number of arguments in favour of an approach based on an updated IAS 37 model,<sup>2</sup> including:

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2 Several of these arguments have been noted by IASB staff. For instance, see Agenda Paper 6E *Current Exit Price* to the June 2009 meeting of the Insurance Contracts Working Group and paragraph 34 of Agenda Paper 11A *Measurement Approach for Insurance Contracts* to the July 2009 joint IASB/FASB meeting.

- (a) at its July 2009 meeting, the IASB confirmed that an entity should measure a liability under IAS 37 at the amount it would rationally pay at the end of the reporting period to be relieved of the present obligation. This amount is arguably an attribute of an obligation. In contrast, a current fulfilment value that includes a composite margin is arguably a computed value for an insurance obligation;
  - (b) the measurement objective in an updated IAS 37 would provide a clear principle for determining the features of a liability measurement approach for insurance contracts. For instance, an updated IAS 37 model provides a basis for risk and service margins being included in the liability measurement because they flow from the measurement objective. In contrast, a composite margin does not flow directly from a current fulfilment objective;
  - (c) requiring an explicit risk margin and, where appropriate, a service margin to be separately measured would provide useful information to users; and
  - (d) the scope of an updated IAS 37 will include liabilities that generate uncertain cash flows, such as warranty obligations. Insurance contracts generate liabilities with uncertain cash flows. Accordingly, to ensure all liabilities with uncertain cash flows are measured on a similar basis, insurance contracts should be measured in a manner consistent with the updated IAS 37 model.
10. There are also a number of arguments in favour of a current fulfilment value approach that includes a composite margin (candidate 3),<sup>3</sup> including:
- (a) a current fulfilment value approach is consistent with the way in which insurers typically conduct their businesses as most insurance contracts are fulfilled over time. In contrast, an approach based on an updated IAS 37 model would require an insurer to measure an insurance contract at the amount they would be willing to pay to be relieved of the contract, which is contrary to way most insurers view their obligations;
  - (b) a current fulfilment value approach would predominantly use market and entity-specific inputs that can be reliably measured. In contrast, an updated IAS 37 model is likely to require entities to estimate market inputs, such as a subcontractor's cash flows;
  - (c) a current fulfilment value that includes a composite margin would be relatively easy to calculate and arguably yield more comparable amounts than an approach based on an updated IAS 37 model, which would include separately measured risk and service margins; and
  - (d) guidance material for measuring the current fulfilment value of an insurance contract could be developed for the specific characteristics of such contracts. In contrast, guidance for measuring insurance contracts under an updated IAS 37 model might be constrained by the guidance contained in the Standard.
11. No clear consensus was reached by IASB members at the July 2009 meeting on the appropriate liability measurement approach for insurance contracts. However, there appears to have been sufficient interest among some members at this meeting for an

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3 Several of these arguments have been noted by IASB staff. For instance, see paragraph 35 of Agenda Paper 11A *Measurement Approach for Insurance Contracts* to the July 2009 joint IASB/FASB meeting.

approach based on an updated IAS 37 model to seek to have the staff clarify how the model would apply to insurance contracts.

12. At the joint IASB and FASB meeting held in July 2009, both Boards discussed the two aforementioned measurement approaches. While the FASB members affirmed tentatively that the objective of the liability measurement is to report a value based on the insurer's fulfilment of its contractual obligations to its policyholders over time, the IASB members remained divided between an approach based on an updated IAS 37 model and a current fulfilment value approach.

### **An approach based on an updated IAS 37 model**

13. Concerns expressed by some IASB members at the July 2009 meeting are that:
  - (a) the IASB has not completed its deliberations on the proposed amendments to IAS 37; and
  - (b) the likelihood that an updated IAS 37 model would need to be modified for application to insurance contracts. For instance, the updated IAS 37 model does not explicitly deal with revenue generating contracts with customers. Because insurance contracts are such contracts, the IASB will need to consider some issues not addressed in the updated IAS 37 model, such as the treatment of residual margins to ensure that insurers do not recognise 'day-one' gains.
14. At its July 2009 meeting, the IASB discussed proposed amendments to the measurement requirements in IAS 37 and decided tentatively that:
  - (a) the amount an entity would rationally pay to be relieved of the present obligation is the lower of:
    - (i) the value to the entity of not having to fulfil the obligation; and
    - (ii) the amount that the entity would have to pay to cancel the obligation or transfer it to a third party; and
  - (b) if there is no evidence that the entity could cancel the obligation or transfer it to a third party, the entity measures the obligation at the value of not having to fulfil the obligation.

However, most insurance contracts are not cancelled (commuted). Commutation normally only occurs when the insurer or the policyholder is in financial distress.<sup>4</sup> Moreover, if an insurer could cancel an insurance obligation for less than the value of fulfilling it, the insurer would presumably have already done so. In addition, insurance contracts cannot generally be transferred because there is no active secondary market for such contracts.<sup>5</sup> Accordingly, an obligation arising from an insurance contract under an updated IAS 37 model would most likely be measured at the value to the insurer of not having to fulfil the obligation to the contract holder.

15. While the IASB is still deliberating on its proposed amendments to IAS 37, IASB staff have characterised the value of not having to fulfil an obligation as:

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4 Paragraph 11(a) of Agenda Paper 6D *The Updated IAS 37 Model as a Candidate for Insurance Contracts* to the June 2009 meeting of the Insurance Contracts Working Group.

5 This was the main argument used by respondents to the IASB's Insurance Contracts DP against measuring an insurance obligation at its current exit value.

“...an entity-specific measure. It is a measure of ‘value’, not necessarily of ‘cost’. It could be argued that it would be estimated taking into account:

- (a) the value to the entity of not having to make the payments or undertake the services necessary to fulfil the obligation;
- (b) the value to the entity of not having to bear the risk in the expected cash outflows; and
- (c) the time value of money.

If the entity expects to fulfil the obligation by undertaking a service (such as environmental decontamination) at a future date, the entity could estimate (a) by estimating the amount that it would be willing to pay a contractor at the future date to undertake the service. If an efficient market exists for such services, the amount could be the price that a subcontractor would charge. If there is not an efficient market, the amount could be the price that the entity estimates it would itself charge another party to undertake the service.”<sup>6</sup>

16. AASB staff consider that the value of not having to make the payments or undertake the services necessary to fulfil an obligation might be more appropriately characterised in an insurance context as the amount of premium the insurer would charge at the reporting date to write a new policy for the remaining period of the contract and for the remaining cohort of risks. However, as discussed below, this amount might vary, depending upon the insurer’s circumstances.
17. AASB staff consider that, in some circumstances, the amount of a pre-claims or claims general insurance liability measured under an approach based on an updated IAS 37 model might be similar to the amount of the same pre-claims or claims liability measured under AASB 1023. For instance, in circumstances where the insurer is:
- (a) selling insurance contracts into a competitive market and is equally likely to make a small loss or a small profit on such contracts; and
  - (b) not aiming to either increase or decrease its share of the particular market through its pricing policy,
- the insurer might consider the cost of fulfilling the obligation to approximate the value of not having to fulfil the obligation.
18. However, in other circumstances, the amount of a general insurance liability measured under an approach based on an updated IAS 37 model might differ significantly from the amount of the same liability measured under AASB 1023. For instance, in circumstances where the insurer:
- (a) expects the contract to be very profitable (and therefore considers the value of not having to fulfil the contract to be greater than the cost of fulfilling the contract. In these circumstances, the insurer might be expected to offer a relatively smaller amount to a market participant to relieve itself of the liability than the amount the market participant might require to assume the liability); or

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6 Paragraphs 21 and 22 of Agenda Paper 8A *Liabilities – Amendments to IAS 37* to the IASB’s July 2009 meeting.

- (b) has decided for strategic reasons not directly related to the product that it no longer wants to underwrite a particular line of insurance business and therefore considers the value of not having to fulfil the outstanding contracts to be less than the cost of fulfilling the contracts. The difference between the insurer's value and the cost of fulfilling the contract may be significant in circumstances where, for example, the insurer could avoid large overhead costs from not having to fulfil the insurance contracts; or
  - (c) provides services as part of an insurance contract and the costs incurred by the insurer to provide these services is significantly greater than the amounts other entities would charge the insurer to provide the same services on a stand-alone basis.
19. AASB staff consider that the amount of a life insurance obligation measured under an approach based on an updated IAS 37 model might be similar to the amount of the same obligation measured under AASB 1038 for the reasons identified in paragraphs 17(a) and (b) above. In addition, AASB staff consider that the amount of a life insurance obligation measured under an approach based on an updated IAS 37 model might differ from the amount of the same obligation measured under AASB 1038 for the reasons identified in paragraphs 18(a) – (c) above. However, it is relevant to note that, in respect of paragraph 18(c) above, relatively few life insurers provide additional services (such as fund management services) in respect of their life insurance contracts because most life insurance products offered by Australian insurers are 'unbundled'. Accordingly, life insurance liabilities recognised under AASB 1038 normally only comprise the term life obligation.

#### **FASB's decisions to date on the candidate liability measurement approaches**

20. The Insurance Contracts project is currently being conducted as a joint project between the IASB and the FASB. While both Boards have held joint meetings to discuss insurance contracts, both Boards have deliberated on the candidate liability measurement approaches independently of each other. The following provides a summary of the FASB's decisions to date in relation to the various approaches and, where relevant, how the FASB's decisions differ from the IASB's decisions.
21. The FASB has tentatively agreed that:
- (a) the objective of the liability measurement of an insurance contract is to report a value based on the insurer's fulfilment of its contractual obligations to its policyholders. While fulfilment value is not defined in US GAAP, it would include entity-specific inputs that generally would not require consideration of market participant views;
  - (b) measurement of the fulfilment value of an insurance contract should:
    - (i) use expected (probability weighted) cash flows rather than a best estimate of the cash flows required to fulfil the contractual obligations under an insurance contract. The measurement of those expected cash flows should consider all available information that represent the fulfilment of the insurance contract. All available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when

those inputs are relevant to the fulfilment of the contract. In addition, expected cash flows should be updated each reporting period; and

- (ii) include only a composite margin with no explicit risk margin;
- (c) expected cash flows in the measurement of an insurance liability should be discounted to reflect the time value of money. In addition, the discount rate used should be updated each reporting period; and
- (d) in principle, the initial recognition of an insurance contract should not result in the recognition of an accounting profit but may result in the recognition of an accounting loss; and
- (e) an entity should expense all acquisition costs when incurred and should not recognise any revenue (or income) to offset those costs incurred.

**Other relevant issues in relation to the candidate liability measurement approaches that the IASB is yet to fully deliberate**

- 22. The IASB discussions to date on insurance contracts have focussed predominantly on identifying a candidate liability measurement approach for all types of insurance contracts. Nevertheless, the IASB has discussed some of the issues common to either or both an approach based on an updated IAS 37 model and a current fulfilment value approach that includes a composite margin. While the IASB is yet to make any firm decisions in relation to these issues, they are potentially relevant to the AASB deliberations in relation to accounting for insurance contracts.
- 23. The following discussion provides a summary of these issues and, where relevant, how the accounting treatments identified by IASB staff differ from the treatments currently required under AASB 1023 and AASB 1038.

***Risk margins***

- 24. As noted in paragraph 15 of this Agenda Paper, under an updated IAS 37 model an entity would measure a liability at the amount it would rationally pay to be relieved of the obligation. Accordingly, this amount would include any variations in the amount or timing of future cash flows that affect the amount the entity would pay to be relieved of the obligation. In addition, as the updated IAS 37 model is a current value model, the risk margin would be presumably be remeasured at each reporting date.
- 25. Under a current fulfilment value approach that includes a composite margin, a risk margin is not separately measured. Accordingly, it is feasible that, under such an approach, the initial amount of an insurance obligation would not include a risk margin. For instance, in circumstances where insurance contracts are intentionally sold at a loss for commercial reasons or are mispriced. In these circumstances the entity would presumably be required to apply a liability adequacy test. However, the IASB is yet to deliberate on:
  - (a) the circumstances which would trigger a liability adequacy test being applied to an insurance contract. For instance, would a change in the amount of the risk margin be sufficient to trigger a liability adequacy test being applied; and

- (b) whether under the proposed current fulfilment value approach an insurance obligation that is remeasured as a consequence of a liability adequacy test being applied would include a separately measured risk margin (as such a margin is not separately measured on initial recognition).
26. As noted in Table 6 of this Agenda Paper, AASB 1023 requires a separate risk margin to be measured in respect of pre-claims general insurance liabilities that have had a liability adequacy test applied to them, and claims liabilities. For pre-claims liabilities that have not been subject to a liability adequacy test, an implicit risk margin would normally be expected to form a part of the composite margin at the inception, as implied by the premium. In addition, as noted in Table 7 of this Agenda Paper, the risk margins attributable to both pre-claims liabilities that have been subject to a liability adequacy test and claims liabilities are required to be remeasured at each reporting date and any changes recognised in the profit or loss.
27. With regards to life insurance liabilities, AASB 1038 requires planned margins of revenues over expenses, which include a risk margin, to be released to profit or loss over time in accordance with an appropriate driver, such as release from risk. Accordingly, as noted in Table 7 of this Agenda Paper, a remeasurement change in the risk margin would only be recognised when a liability adequacy test determined that the present value of future expenses exceeds the present value of future revenues attributable to the contract. Any such remeasurement changes in risk margins would be recognised in profit or loss under AASB 1038.

*Service margins under an updated IAS 37 model*

28. The amount of an insurance contract under an approach based on an updated IAS 37 model would include, when relevant, a margin for services. While the IASB has yet to deliberate on what services would be considered to be a part of an insurance contract, IASB staff note 'fund management services' and 'car repairs' might represent two types of such services.<sup>7</sup> In addition, under an updated IAS 37 model, a service margin would be based on the profit a contractor would require for undertaking the service or, if there is no efficient market for such services, the profit the insurer would itself require to provide such services.
29. Under AASB 1023, service margins form a part of the implicit margin set at inception on a general insurance contract. In contrast, the estimated costs to the insurer of providing future services to policyholders would be explicitly incorporated into the measurement of the cash flows in respect of pre-claims general insurance liabilities that have been subject to a liability adequacy test and claims liabilities.
30. With regards to life insurance liabilities, service margins would be incorporated into the planned margins of revenues over expenses under AASB 1038 and calculated based on the insurer's estimated costs of providing the relevant services.

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<sup>7</sup> Paragraph 25 of Agenda Paper 6D *The Updated IAS 37 Model as a Candidate for Insurance Contracts* to the June 2009 Insurance Contracts Working Group meeting.

### *Remeasurement of composite margins*

31. The IASB is yet to consider whether the composite margin included in a current fulfilment value should be remeasured for changes in estimates. Nevertheless, the IASB staff have expressed concerns with not remeasuring composite margins because such an approach presumes that the premium at inception provides the best evidence of the margin, and no subsequent information will provide better evidence of the margin. In particular, IASB staff expressed concerns that:
- (a) while it could be argued that a decrease in risks is captured by part of the composite margin being released to the profit or loss, changes in the price of insurance contracts as a consequence of increases in risks would not be captured when a risk margin is not separately calculated; and
  - (b) the approach is overly simplistic. For instance, variability of cash flows is an inherent characteristic of insurance contracts. Accordingly, if risk is not measured explicitly, it would arguably be difficult to determine whether the composite margin on an insurance obligation is an appropriate depiction of the inherent variability in the underlying cash flows. In addition, the impact of not measuring the risk margin explicitly in circumstances where the variability of the underlying cash flows is increasing or decreasing could be amplified if the measurement approach absorbs some or all changes in estimates of the composite margin,<sup>8</sup> as discussed below.
32. Some argue that, under a fulfilment value approach, changes in non-financial variables, such as mortality rates, lapse rates and expenses, should be recognised as a reallocation within an insurance liability between the fulfilment value and the value of any composite margin. As the objective of the fulfilment value approach is to measure the overall margin that the insurer expects to earn based on current expectations, if the fulfilment value changes then the margin should also change, except where the margin becomes negative. In such circumstances, the change in the amount of the insurance liability would be recognised in the profit or loss in the period in which it occurred. Therefore, unless an insurance contract became onerous, changes in estimates would be reflected in the release of margins to the profit or loss in future periods rather than in the current year's profit or loss.
33. IASB staff note there are a number of arguments in favour of this approach, including:
- (a) it is consistent with the overall approach under a current fulfilment value, which is to look at changes in the total insurance liability, including the margin;
  - (b) differences between the actual cash flows for a reporting period and the most recent estimates of cash flows are included in the profit or loss in the period in which they arise. In addition, the reporting of subsequent changes in estimates and the impact those changes have on margins could be achieved by disclosing, for instance, period-to-period changes in margins;
  - (c) if an insurer were to recognise changes in the estimates of non-financial variables in the profit or loss, an insurer might recognise income or expense in one period and, as a consequence of subsequent changes in estimates, recognise an expense

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8 Paragraph 27(b) of Agenda Paper 5A *Margins* to the IASB's April 2009 meeting.

- or income in the following period that reverses the income or expense recognised in the previous period; and
- (d) it is consistent with the allocated transaction price approach proposed by the IASB for revenue recognition.
34. IASB staff also note that there are a number of arguments against this approach, including:
- (a) the composite margin would operate as a shock absorber rather than a measure of the components that make up the difference between the premium charged and the obligation incurred;
- (b) it could lead to situations where insurance liabilities with different variabilities of underlying cash flows are measured at the same amount; and
- (c) it is inconsistent with the measurement approaches applied to other liabilities.<sup>9</sup>
35. As noted in paragraph 26 of this Agenda Paper, only pre-claims liabilities under AASB 1023 would include a composite margin. Under this Standard, such margins would only ever be remeasured when a liability adequacy test found that the contracts are onerous, in which case AASB 1023 requires a separate risk margin to be calculated.
36. In contrast to the approach under AASB 1023, all life insurance liabilities under AASB 1038 include a composite margin in the form of planned margins of revenues over expenses.

***The basis on which a composite margin should be released to profit or loss***

37. This brief discussion on the basis on which a composite margin should be released concerns two factors – the period over which margins should be released and the pattern of release over the relevant period.
38. Because a composite margin potentially comprises a number of components, including a risk margin, a service margin, amounts for recovery of acquisition cost and/or measurement errors, release from risk might not be the appropriate driver for the release of such margins in all circumstances. Other drivers would include expected benefit payments, expected claims and the passage of time.
39. The IASB is yet to deliberate on whether composite margins should be released over:
- (a) the pre-claims period only; or
- (b) the full term of the liability, including the period to settlement.

IASB staff note that, for life insurance contracts, the claims period typically is very short. Accordingly, the two approaches might provide similar outcomes.<sup>10</sup> However, this ignores the affect that different lapse rate assumptions can have on the estimated length of a life contract. The IASB are yet to deliberate on estimated lapse rates.

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9 Paragraphs 20-27 of Agenda Paper 5B *Residual and Composite Margins* to the IASB's April 2009 meeting.

10 Paragraphs 26-28 of Agenda Paper 6B *Key Measurement Issues* to the June 2009 meeting of the Insurance Contracts Working Group.

40. If the IASB were to decide that composite margins should be released over the full term of the liability, including the period to settlement, this would probably raise questions about whether more than one 'driver' would be appropriate. For instance, while risk might be an appropriate driver during the pre-claims period, the passage of time might be considered a more appropriate driver during settlement periods, particularly when the amounts of claims tend to vary with the length of time it takes to settle them.
41. Under AASB 1023, any composite margin in relation to pre-claims liabilities that have not been subject to a liability adequacy test would be released to the profit or loss over the contractual period of coverage in accordance with an appropriate risk driver. In most cases, this risk driver will be the passage of time as this would be a reasonable proxy for release from risk.
42. AASB 1038 requires that planned margins of revenues over expenses be released to profit or loss based on one or more 'factors' or 'profit carriers', which correspond to the performance of services and the earning of the margins. Paragraph 8.2.2 of AASB 1038 notes that, in relation to many life insurance products, the profit carrier might be premiums or claims.

***The boundary between existing contracts and new contracts***

43. At its May 2009 meeting, the IASB tentatively agreed that the starting point in determining the boundary between existing contracts and new contracts would be whether the insurer can cancel the contract or change its pricing or other terms. The boundary between an existing contract and a new contract is relevant to determining, for instance, which cash flows would be included in the measurement of an insurance obligation. IASB staff intend to develop more specific proposals to be considered at a future meeting.
44. Currently, there is no specific guidance in AASB 1023 regarding the boundary between existing contracts and new contracts. In the context of AASB 1038, this issue is linked to the estimated lapse rate.

**AASB staff views**

45. To assist the Board in identifying the issues on which it might wish to provide input to the IASB in advance of the IASB's forthcoming ED on insurance contracts, staff have identified the following.

***Insurers should not be required to recognise 'day-one' losses on insurance contracts unless the contracts are deemed onerous.***

46. An insurer usually incurs costs to establish a contract with a policyholder and a 'day one' loss would normally arise if those costs are recognised immediately as expenses. In these circumstances, an insurer that writes relatively more policies than another insurer is likely to report less profits than its competitor, irrespective of whether the new policies represent 'good' risks and are priced correctly.
47. One way of avoiding the recognition of 'day one' losses is to defer acquisition costs. AASB 1023 requires acquisition costs incurred in obtaining and recording general

insurance contracts to be recognised as assets and then systematically amortised in accordance with the expected pattern of the incidence of risk under the related contracts. However, the IASB does not support this approach.

48. To avoid ‘day-one’ losses, the IASB has tentatively decided that, at the inception of an insurance contract, an insurer should recognise as revenue that part of the premium that covers acquisition costs. Subject to the IASB’s decisions on what constitutes ‘acquisition costs’, staff prefer the IASB’s proposed approach over the current requirements under AASB 1023. Staff consider that, in some circumstances, it may be difficult for acquisition costs to meet the asset definition and recognition criteria in the *Framework for the Preparation and Presentation of Financial Statements*.

***Entities should be permitted but not required to apply an unearned premium approach for pre-claims liabilities of short-duration insurance contracts.***

49. Staff consider an unearned premium approach could provide a useful measure of short-duration insurance liabilities without imposing on insurers additional actuarial and accounting costs. However, by requiring (rather than permitting) an unearned premium approach to be applied, insurers would be prohibited from using a prospective approach (based on expected future cash flows), even when they consider the prospective approach would provide more useful information than an unearned premium approach. Accordingly, staff consider that an unearned premium approach should be permitted for short-duration insurance liabilities when the outcome would be materially the same as the outcome from applying the principal liability measurement approach. Furthermore, staff consider that ‘short term’ should be determined on the basis of the likely time to settle claims, not only the duration of the contract itself.

***The principal liability measurement approach should comprise the ‘building blocks’ identified in the IASB’s Insurance Contracts DP.***

50. The IASB’s proposed ‘building blocks’ for insurance contracts comprise:
- (a) explicit unbiased estimates of the expected (probability weighted) future cash flows;
  - (b) time value of money; and
  - (c) an explicit margin.
51. Staff consider these ‘building blocks’ to be the minimum components of any prospective measurement model. In addition, staff consider that expected (probability weighted) future cash flows are preferable to a ‘best estimates’ (mean) measure of cash flows as insurance claims are generally not ‘normally’ distributed in a statistical sense.
52. As noted in paragraph 21 of this Agenda Paper, the FASB has tentatively agreed that the IASB’s proposed ‘building blocks’ should form the basis of any proposed measurement approach for insurance contracts.

***The measurement objective should be current fulfilment value.***

53. Staff prefer a current fulfilment value approach over an approach based on an updated IAS 37 model because a current fulfilment value approach:

- (a) is consistent with the way in which insurers typically conduct their businesses. Accordingly, a current fulfilment value approach would arguably facilitate the provision of useful information about an insurer's:
    - (i) estimate of its level of future claims; and
    - (ii) financial position over the longer term; and
  - (b) would predominantly use market and entity-specific inputs that are relevant to an insurer's assessment of its estimated cost of fulfilling insurance contracts. In contrast, as discussed in paragraph 18 of this Agenda Paper, the amount of an insurance obligation measured under an updated IAS 37 model might include inputs that are not directly related to the cost of fulfilling the insurance contracts, such as overhead costs.
54. While there are obvious benefits from having similar measurement requirements apply to similar types of liabilities, staff do not consider an updated IAS 37 model to be an appropriate approach for the IASB to pursue at this time because:
- (a) as noted in paragraph 13 of this Agenda paper, insurance contracts are revenue generating contracts with customers, and the IASB will probably need to consider some issues not addressed in the updated IAS 37 model, such as the use of residual margins, if it does not want insurers to recognise 'day-one' gains. Accordingly, any benefits from using an updated IAS 37 model to align the measurement requirements for insurance contracts with the requirements that apply to other similar liabilities may be limited. In addition, if (as discussed in paragraph 13 of this Agenda Paper) the IASB decides to modify the updated IAS 37 for application to insurance contracts, the resulting measurement method would arguably not be an attribute; and
  - (b) the IASB is still deliberating on its proposed amendments to IAS 37. Accordingly, the implications of the updated model will only be capable of being understood when the proposals are finalised.
55. It is relevant to note that, while the IASB is yet to deliberate on whether credit risk should be incorporated into the current fulfilment value of an insurance liability, a number of respondents to the Insurance Contracts DP argued that non-performance risk is not relevant to current fulfilment value because an implicit assumption underlying the model is that the insurer will fulfil the liability. In addition, some respondents noted that, in practice, the impact of non-performance risk on the value of insurance liabilities is likely to be limited because of credit enhancements to such liabilities by, for instance, regulatory frameworks.

***Insurance liabilities should comprise a risk margin that is separately calculated, consistent with observed market inputs and subject to remeasurement at each reporting date.***

56. Staff consider a separate risk margin to be an essential component of the measurement of an insurance obligation. The purpose of a risk margin is to reflect the level of uncertainty surrounding the cash flows attributable to insurance obligations. Accordingly, risk margins assist users in distinguishing between different insurance liabilities that have differing levels of uncertainty in respect of their cash flows.

57. While a composite margin would include an implicit risk margin, the failure to calculate a separate risk margin could lead to situations where two insurance obligations with different levels of uncertainty associated with their cash flows are measured at similar amounts.
58. The levels of uncertainty associated with the cash flows attributable to insurance obligations can change over time. Accordingly, staff consider that risk margins should be:
- (a) subject to remeasurement at each reporting date; and
  - (b) released to profit or loss as the insurer is released from risk.
59. AASB 1023 currently requires a risk margin to be separately calculated for the purpose of measuring insurance claims liabilities (but not pre-claims liabilities). Accordingly, staff consider that any changes to the measurement of insurance liabilities by the IASB that does not require a separate risk margin to be measured would be a backward step in the Australian context.

***The inputs used to measure current fulfilment value should be as consistent as possible with observable market information.***

60. To facilitate the comparability of insurer's financial statements, staff consider that an insurer's estimate of the cash flows it would incur in fulfilling its obligations to policyholders should be as consistent as possible with observed market inputs. Inputs for which observable market information is likely to be available would include mortality rates, inflation rates, claims escalation rates and discount rates. When market variables are unavailable or cannot be derived on a reliable basis, insurers would apply entity-based information.

***Where an unearned premium approach is not applied:***

- (a) ***the inputs used to measure current fulfilment value should be subject to remeasurement at each reporting date; and***
  - (b) ***remeasurement changes in estimated cash flows should be recognised in profit or loss in the period in which they arise.***
61. These proposals are consistent with AASB 1023 in respect of claims liabilities and are also consistent with the overall thrust of the 'prospective approach' underlying AASB 1038, however they differ from the current approach under AASB 1038 in some important ways. As noted in Table 4 of this Agenda Paper, under AASB 1038:
- remeasurement changes in estimated cash flows of life insurance contracts are included in the profit or loss as they arise when they relate to 'unprofitable' contracts or changes in discount rates and other economic assumptions;
  - however, remeasurement changes in estimated cash flows are recognised in profit or loss in the future reporting periods over which the contract is expected to be outstanding by adjusting the planned margins.
62. Staff note that adjusting planned margins to spread the impact of changes in assumptions regarding expected future revenues and expenses over the remaining life

of an insurance contract is consistent with aspects of the model underlying AASB 1038. AASB 1038 contemplates an obligation arising from a life insurance contract including a composite margin that comprises, among other things, a profit margin that is based on the assumptions employed in setting the premium. Under that model, changes in assumptions can be viewed as changing the profit margin, which can continue to be spread over future reporting periods during which the insurer provides risk-bearing services. Nevertheless, staff consider that this approach:

- (a) could give rise to outcomes that are inconsistent with the proposal that insurance liabilities should comprise a separate risk margin;
  - (b) is inconsistent with the treatment of differences between assumed and actual cash flows; and
  - (c) gives rise to information that is arguably not neutral (free from bias) and, therefore, would be inconsistent with the *Framework's* qualitative characteristics.
63. Under AASB 1038, a change in, for instance, the estimated level of future claims administration expenses in respect of 'profitable' contracts could reduce an insurer's planned margins to an amount less than the insurer's estimated risk margin without triggering a liability adequacy test. In such circumstances, users might conclude that the insurer's central estimate of its expected future payments has not changed, when in fact it has.
64. Staff note that treating the implications of some changes in assumptions as changes in the planned margins is inconsistent with the treatment of the implications of:
- (a) most other changes in assumptions under AASB 1038; and
  - (b) changes in assumptions under other Accounting Standards that prescribe the measurement of liabilities, such as AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*.

Accordingly, staff consider it would be preferable to move to a model under which all of the implications of changes in assumptions and differences between assumed and actual cash flows are recognised in profit or loss in the period in which they arise for consistency with other relevant liability measurement requirements and in the interests in there being a separate risk margin.