Preliminary Issues Paper – ED 244 *Insurance Contracts* (incorporates IASB ED 2013/7 *Insurance Contracts*)

1 Introduction

1.1 The purpose of this issues paper is to outline potential issues in ED 244 *Insurance Contracts* and decide whether these issues, or any other issues, should be included in the AASB's submission on IASB ED/2013/7 *Insurance Contracts*.

1.2 Comments are due to the IASB by 25 October 2013 and are due to the AASB on 27 September 2013. Roundtables on ED 244 are scheduled for 3 September 2013 (Sydney) and 12 September 2013 (Melbourne/Auckland). IASB members and staff will attend the Sydney Roundtable via videoconference.

1.3 No submissions have been received by the AASB as at the date of this Issues Paper. This Issues Paper incorporates informal feedback received to date in response to ED 244 as a result of considerable informal liaison conducted by staff over the past month.

1.4 Due to the timing of the comment period staff recommend that the AASB's submission to the IASB is finalised at the 23-24 October Board meeting.

2 Background

2.1 An update on the IASB's Insurance Contracts project was provided to the Board's at its April 2012 meeting as agenda paper 14.1. At that meeting staff presented an Issues Paper, being a broad outline of progress to date on Insurance Contracts as agenda paper 14.2.

2.2 Prior to that, and as a result of discussion at the June 2011 AASB meeting on the IASB's progress, the AASB had sent a letter dated 5 July 2011 to the IASB expressing views on the issues of contract boundary, risk margins, residual margins, having one measurement model, and presentation of margin information. The letter can be located here. In the staff's view the issues raised in the AASB's letter have been responded to in the proposals in the IASB's ED/2013/7.

2.3 The IASB previously issued ED/2010/8 *Insurance Contracts* in July 2010 (incorporated into the AASB's ED 201 issued in August 2010). The AASB submitted a comment letter to the IASB on ED/2010/8 jointly with the New Zealand Financial Reporting Standards Board (FRSB). The submission to the IASB on ED/2010/8 can be located here.

2.4 The IASB is seeking input only on the significant changes it has made in response to the feedback it received on its proposals in its 2010 exposure draft. This paper is structured to correspond to the questions asked by the IASB in ED/2013/7 but also includes discussion on issues for which the IASB has not directly sought comment.

2.5 The following key issues are discussed in this paper. Question numbers in brackets refer to the question numbers in the IASB's 2013 ED[1]:

(a) Adjusting the contractual service margin (Question 1);

(b) Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (Question 2);

(c) Presentation of insurance contract revenue and expenses (Question 3);

(d) Interest expense in profit or loss (Question 4);

(e) Effective date and transition (Question 5); and

(f) Separating insurance contracts from investment contracts ('unbundling').

3 Adjusting the Contractual Service Margin (Question 1)

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows, if:

a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

IASB proposals

3.1 Paragraph 18 of ED/2013/7 proposes an insurance contract be measured initially at the sum of (a) the amount of the fulfilment cash flows plus (b) any contractual service margin (CSM). According to paragraph 19 of ED/2013/7, the resulting measurement can be regarded as comprising two elements: (i) a liability for remaining coverage and (ii) a liability for incurred claims.

- Fulfilment cash flows are defined as 'an explicit, unbiased and probability weighted estimate (ie expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment'.

- CSM is defined as 'a component of the measurement of the insurance contract representing the unearned profit that the entity recognises as it provides services under the insurance contract'.

1 Questions 6 and 7 in ED/2013/7 are in respect of the likely effects and clarity of drafting of the proposals. The staff do not intend to consider these questions directly at the AASB's September meeting.

3.2 The initial measurement proposed is similar to the proposal in paragraph 17 of ED/2010/8 that an insurance contract be measured as the present value of the expected cash inflows and outflows to fulfil the contract, adjusted for uncertainty of amount and timing, plus a residual margin that eliminates any gain at inception.

3.3 A simplified approach, the 'premium-allocation approach' or 'PAA', is permitted to be used under the 2013 proposals if doing so would produce a measurement that is a reasonable approximation of the full approach (also referred to as the 'building-block approach' or 'BBA'), or the coverage period of the insurance contract at initial recognition is one year or less. The PAA would apply only to the component of an insurance liability that is a liability for remaining coverage. It would not apply to the component of an insurance liability that is a liability for incurred claims.

3.4 Paragraphs 30-32 of ED/2013/7 propose that, unless the simplified approach is used 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 remaining amount of the CSM at reporting date is determined under the proposals as follows:

Opening carrying amount

\+ interest accreted on the CSM to reflect the time value of money (accreted at the discount rate that applied when the contract was initially recognised)

– the amount of CSM recognised in the period (for services provided in the period)

+/– favourable/unfavourable differences between current and previous estimates of the present value of future cash flows relating to future coverage and future services (provided the CSM does not become negative).

The remaining CSM is to be recognised in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the contract. Paragraph 25 of ED/2013/7 proposes that the estimates of cash flows are adjusted for the time value of money by using discount rates that reflect the characteristics of the cash flows. The discount rate is consistent with observable current market prices for instruments with characteristics consistent with those of the insurance contract for timing, currency and liquidity but excludes factors that are not relevant to the insurance contract.

Current requirements

3.5 AASB 1023 *General Insurance Contracts* requires an approach that is largely the same as the simplified (PAA) approach. A liability for remaining coverage is measured as a portion of premium (the deferred portion) and a liability for incurred claims relating to the expired period of coverage is measured as the present value of expected cash inflows and outflows to fulfil the contract, adjusted for inherent uncertainty in the central estimate with an additional risk margin.

3.6 AASB 1038 *Life Insurance Contracts* requires an approach that is similar to the BBA with contract liabilities being measured as the present value of best estimate cash flows plus a planned margin that eliminates any gain at inception. Planned margins are recognised in income as services are rendered based on one or more 'profit carriers'. The impact of changes to assumptions are adjusted in the planned margins and the differences between actual and assumed experience in relation for risks already borne are recognised as income or expense as they occur. If the result would not be materially different, AASB 1038 permits measurement at the accumulated benefit after allowing for acquisition costs expected to be recouped.

3.7 Under both AASB 1023 and AASB 1038, cash flows are discounted for the time value of money using risk-free discount rates based on current observable, objective rates that relate to the nature, structure and term of obligations. To the extent liabilities are contractually linked to the performance of assets, the discount rates are based on market returns on assets backing life insurance liabilities.

AASB staff preliminary comments

3.8 In very broad terms, the proposals in ED/2013/7 are similar to the requirements under AASB 1023 and AASB 1038. However, some constituents are concerned about the complexity of implementing the proposals and the potential for lack of understanding by users. They observe that while at a high level similarities exist between current AASB 1038 and AASB 1023 requirements and the proposals, the 'devil is in the detail' and only with further analysis could the full impact of the proposals be assessed.

3.9 Unlocking the CSM

3.9.1 Staff consider that the basis for the CSM in ED/2013/7 (as a margin that reflects obligations to provide future services) probably justifies the CSM to some degree. However, that description is probably is only partially true, and the explanation in the IASB's earlier ED/2010/8 that the residual margin is one that eliminates any gain at inception is perhaps a more accurate depiction of the reasoning. However, if we accept that a gain at inception is not to be recognised, and that the CSM relates at least in part to future services, staff generally support the ED/2013/7 proposals.

3.9.2 In particular, staff support unlocking the CSM and note that the main alternative would be to lock in a type of amortisation rate for the CSM at inception, which makes no allowance for changes in circumstances. Informal feedback indicates that some Australian constituents also support the proposals to remeasure the CSM.

3.10 *Impact of change in experience*

3.10.1 Staff support the proposal that the impact on the CSM of a difference between assumed and actual experience is recognised immediately in profit or loss on the basis that it relates to risks borne in the period. Staff also support the proposal that the impact on the CSM of a change in assumptions is recognised as an adjustment to the CSM on the basis that it relates to risks to be borne in future periods and can be regarded as akin to a new policy being written at reporting date for the remaining period of the relevant contracts. Staff note that ED/2013/7 proposes that the CSM cannot be negative (paragraph 30(d)(ii)).

3.11 *Discounting*

3.11.1 Although on the face of it, the requirement to discount cash flows does not seem dissimilar to current requirements, the discount rates proposed in the ED are likely to be somewhat different from those currently being employed by Australian insurers and they would therefore likely require changes to existing systems in order for the proposals to be adopted. The key difference between the proposals compared to AASB 1038 and AASB 1023 is the explicit consideration of liquidity risk. Staff note that currently some life insurers already incorporate liquidity risk in their discount rate.

3.11.2 Some preparers have concerns about the discount rate proposed, in particular concerning the granularity required (ie should discounting be applied at the individual contract level or at a less granular level such as cohorts of contracts with similar initial recognition date or by annual 'vintages' of contracts).

3.11.3 Determining appropriate historic discount rates to be used has also been identified as a potential operational challenge on transition, in particular, for long-dated insurance contracts.

3.12 *Simplified approach*

3.12.1 Staff support the simplification proposed by the IASB to allow the PAA to be used (subject to meeting certain criteria). Staff support the proposal that the simplification is made available as a non-mandatory option, to permit insurers that wish to apply the BBA model instead, for example where similar contracts would otherwise be required to be accounted for using different models. Allowing the simplified approach as a choice may avoid the need for some insurers to have two different systems in place for similar contracts and to explain two sets of results to users.

4 Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (Question 2)

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) 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?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

IASB proposals

4.1 Paragraph 33 proposes that an entity measures fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items. Fulfilment cash flows that are not expected to vary directly with returns on underlying items would have the 'normal' requirements applied to them.

Current requirements

4.2 Currently there are no equivalent 'mirroring' provisions in Australian Accounting Standards for insurance accounting other than under AASB 1038 for liabilities that are contractually linked to the performance of assets. Under AASB 1038, to the extent liabilities are contractually linked to the performance of assets, the discount rates are based on market returns on assets backing life insurance liabilities.

4.3 Staff are not aware of any general insurance contracts that would be affected by the proposals.

AASB staff preliminary comments

4.4 Conceptually staff can understand the rationale for 'mirroring' accounting, since in the limited situations where mirroring is applied economic mismatch is eliminated. However, the mandatory nature of the exception could result in insurance liabilities being measured on a different basis from other similar insurance liabilities on the grounds of the specific arrangements in place. However, some preparers have indicated support for the proposals and the perceived benefit of eliminating mismatches.

4.5 Staff expect that operational complexities are likely to exist in respect of applying mirror accounting:

- for contracts where some cash flows vary directly with the underlying assets and some cash flows do not;

- with the interaction of 'mirroring' and the presentation of amounts in 'other comprehensive income'; and
- on transition.

5 Presentation of insurance contract revenue and expenses (Question3)

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

IASB proposals

5.1 Paragraphs 56-59 propose that an entity presents revenue relating to insurance contracts, incurred claims and other expenses relating to an insurance contract in the statement of profit or loss and OCI. 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 profit or loss and OCI is to exclude any investment components that have not been separated (unbundled from insurance contracts).

Current requirements

5.2 Under AASB 1038 premiums received are recognised as revenue and a claims liability (and related expense) is also recognised based on a prospective cash flows approach (similar to BBA under ED/2013/7). Under AASB 1023 premium revenue is recognised over the period of the contract based on the pattern of the incidence of risk expected. The initial claims liability is the deferred premium (similar to PAA under ED/2013/7). Paragraph 9.1 of AASB 1023 imposes a liability adequacy test and, if the present value of expected cash flows exceeds unearned premium, a loss is recognised immediately.

5.3 AASB 1023 paragraph 17.1, requires the following, and implies that they should be presented on the face of the income statement:

- premium revenue (direct);
- reinsurance premium revenue;
- reinsurance and other recoveries;
- net claims incurred showing separately:
  - (a) amount for risks borne in current period;
  - (b) amount for reassessment of risks borne in previous periods;
- underwriting result;
- gross claims incurred (undiscounted); and
- reinsurance and other recoveries (undiscounted).

5.4 AASB 1038 paragraphs 16.1, 17.1, 17.2 and 18.1, require a substantial number of disclosures relating to the statement of income and they are too numerous to list here. Suffice to say, the income statement includes revenues recognised and the focus of most of the note disclosures is on the components of the changes in claims liabilities.

AASB staff preliminary comments

5.5 AASB staff support the proposals as the presentation proposed would generally bring insurers in line with non-insurers. As noted in paragraph BC76 of ED/2013/7 the proposals should be broadly consistent with the general principles in the IASB's 2011 Exposure Draft *Revenue from Contracts with Customers*, such that an entity would depict the transfer of proposed coverage and other services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the coverage and other services, as it satisfies its performance obligations. Accordingly, an insurer would not include investment components in revenue.

5.6 Feedback from preparers indicates that there is broad support for these proposals and this approach is preferred to the 'summarised margin' approach of ED/2010/8 which proposed presenting volume related information on the face of the profit or loss.

5.7 Staff note that 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.

5.8 Furthermore, aligning presentation with non-insurers allows diversified financial institutions to present information on a similar basis, rather than presenting insurance related items in a different manner.

5.9 Staff consider that volume related information is more usefully disclosed in the notes rather than the primary statements.

6 Interest expense in profit or loss (Question 4)

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items,

the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

IASB proposals

6.1 Paragraph 64 of ED/2013/7 proposes that an entity recognise and present in OCI the difference between the carrying amount of the insurance contract measured using the discount rate specified in paragraph 25 (refer to paragraph 3.11 of this paper) that applied at the reporting date and the discount rate at initial recognition.

6.2 As an exception, if 'mirroring' accounting is applied, the 'mirrored' cash flows are recognised in profit or loss or OCI on the same basis as the change in the value of the underlying items. Cash flows in mirrored contracts that are expected to vary indirectly with underlying items are recognised in profit or loss, and cash flows in mirrored contracts that are not expected to vary with underlying items are recognised in profit or loss and OCI.

Current requirements

6.3 Under AASB 1023 and AASB 1038 all changes in insurance liabilities are presented in profit or loss. This is consistent with the proposals in ED/2010/8 paragraph 76 which proposed that an entity present all income and expense from insurance contracts in profit or loss.

AASB staff preliminary comments

6.4. Consistent with many Australian constituents, staff have strong reservations about the proposals to present amounts in OCI. Our concerns are two-fold: firstly from a conceptual point of view and secondly from an operational perspective.

6.5 *Conceptual concerns*

6.5.1 Staff consider that the proposal for presentation of changes in insurance liabilities due to changes in discount rates is flawed for the following reasons:

(a) The proposals effectively create another measurement model, being a current value model with features of amortised cost. This would add to the already complex array of measurement models in IFRS and is inconsistent with the IASB's objective in the context of its financial instruments project to improve the usefulness of financial statements for users by simplifying the classification and measurement requirements.

(b) Only the change in discount rate (as required to be determined) would be recognised through OCI. Other changes in estimates of cash flows arising from other variables, including inflation, would remain recognised in profit or loss. It might be expected that a 'natural hedge' would exist with changes in inflation being offset by changes in discount rates. The isolation of discount rate changes in OCI may create artificial profit or loss volatility as the impact of naturally offsetting variables is recognised in profit or loss and OCI.

6.5.2 The IASB has justified its proposals in paragraphs BC117 to BC159 of ED/2013/7. In particular the IASB's main justification in paragraph BC 119 is that a clearer presentation of 'underwriting performance and investment performance' is given by presenting an approximation of the 'amortised cost view of the time value of money' in profit or loss. The mention of the presentation of investment performance appears to indicate that the IASB has linked its justification for the proposed treatment of liabilities with the treatment of assets backing insurance contracts.

6.5.3 Staff note that the outcome of the IASB's ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* has not yet been determined. That ED cites the interaction with the Insurance Contracts project as a driver, yet the connection between the two proposals does not seem to have been clearly articulated. That ED proposes introduction of a measurement category for basic debt instruments to be at fair value through OCI (FVOCI). Staff note the following in this respect:

(a) The IASB appears to be supposing that all assets backing insurance liabilities would be financial assets at FVOCI (with an 'amortised cost view' of those assets being recognised in profit or loss and a fair value measure on balance sheet). However, not all assets backing insurance liabilities are necessarily financial instruments, and nor would those assets that are financial assets necessarily meet the criteria in ED/2012/4 to be measured at FVOCI under the IASB's proposals.

(b) A logical extension of the IASB's justification in paragraph BC119 would be to require that all assets backing insurance liabilities be mandatorily at FVOCI and all movements in insurance liabilities going to OCI to achieve an amortised cost profit or loss measure.

(c) A further difference arises since the proposals for debt instruments measured at FVOCI differ from the existing IFRS 9 accounting for equities designated at FVOCI in that the former would involve recycling of amounts from OCI to profit or loss, whereas the latter would not involve recycling.

6.5.4 Furthermore, it is not clear what designations for hedge accounting would be available for insurers under the forthcoming chapter of IFRS 9 on general hedge accounting. It is also not clear whether the IASB has considered the interaction of those forthcoming requirements with the classification and measurement proposals and the insurance proposals.

6.5.5 The recognition of all changes in measurement in profit or loss is considered by many to be a superior basis than the approach in the ED. The OCI approach proposed in the ED will add complexity to the income statement, particularly where discount rates rise and fall over successive periods. There will potentially be both debits and credits flowing to OCI in each reporting period, arising from insurance liabilities with various different initial recognition points.

6.5.6 Staff are also concerned about the continued extension of the use of OCI in the absence of a conceptual basis for OCI. This concern is particularly highlighted since the IASB's Discussion Paper on its Conceptual Framework is scheduled to be issued later in 2013 and is expected to cover this topic.

6.6 *Operational concerns*

6.6.1 Staff have identified the following operational challenges which may arise in implementing the proposals:

a) The proposal would involve identifying and tracking of the discount rate of a contract at initial recognition.

b) It is not clear what unit of account should be employed for tracking discount rates. The possibilities include tracking on a policy-by-policy basis, tracking by all contracts incepted within a portfolio each month or each quarter or each year, or perhaps each time discount rates change. Depending on how the IASB explains the unit of account for tracking discount rates, the systems issues for insurers could be overwhelming.

c) ED/2013/7 is written only from the perspective of discount rates at contract inception differing from subsequent discount rates. It does not seem to have acknowledged that the larger problem could arise for claims liabilities that can be estimated at contract inception, but usually change as more information becomes available. ED/2013/7 does not explain whether the initial discount rate that would need to be tracked would be determined as at the inception date of the contract to which the claim relates, or when an insurer becomes aware of a claim or an occurrence of an event that is expected to give rise to a claim. Again, depending on how the IASB explains the unit of account for tracking discount rates, the systems issues for insurers could be overwhelming.

6.7 Staff consider that the AASB's submission should oppose the proposal on both conceptual and operational grounds. Although the IASB has indicated that it wants to have consistent and comparable reporting, as a fall-back position, the staff recommend the AASB's submission seek an option for insurers to be able to include all changes in insurance liability measurement through profit or loss.

7 Effective date and transition (Question 5)

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

IASB proposals

7.1 Paragraphs C1-C13 propose retrospective application (unless impracticable) of the proposed requirements in ED/2013/7 in accordance with IAS 8 *Accounting Policies, Changes in Estimates and Errors*. A simplified approach is proposed for when full retrospective application is not practicable. Under the simplified approach the entity takes into account all objective evidence that is reasonably available without needing to undertake exhaustive efforts.

7.2 The IASB proposes in paragraph C11 that an entity is permitted, but not required to redesignate a financial asset measured at fair value through profit or loss if it meets the conditions of IFRS 9 *Financial Instruments* at the date when the new insurance contracts standard is first applied ie. if it eliminates or significantly reduces a measurement or recognition inconsistency (an 'accounting mismatch').

7.3 The ED does not include a specified effective date, but indicates in paragraph C1 that the effective date would be approximately three years from the date of publication with early application being permitted.

AASB staff preliminary comments

7.4 As noted above, staff have identified a number of operational concerns in respect of retrospective application of the proposals. However staff's preliminary view is to support the proposed transitional arrangements on the grounds that this would provide users with more relevant and useful information than the previous proposals in ED/2010/8 which would have resulted in no CSM being recognised for contracts in force at the beginning of the earliest period presented. Although this approach is likely to result in significant costs being borne by preparers, staff expect that the resulting benefit would be likely to exceed the costs.

7.5 Staff consider that it would be preferable if the mandatory effective dates of the insurance contracts and financial instruments standards are aligned due to the two standards being interrelated, with some interdependent accounting options between the two, in particular for elective designation of items to be measured at fair value through profit or loss to address 'accounting mismatches'. Staff are aware that some Australian constituents are of the same view.

7.6 The mandatory effective date for IFRS 9 is currently annual reporting periods beginning on or after 1 January 2013, however at its July meeting the IASB decided to defer the effective date to an unspecified date, pending completion of the phases on classification and measurement and impairment.

8 Separating insurance contracts from investment contracts ('unbundling')

IASB proposals

8.1 Some insurance products are bundled with investment contracts. ED/2013/7 paragraph 10(b) requires an entity to separate a distinct investment component from a host insurance contract on the basis set out in Appendix B.

8.2 Paragraph B31 sets out a principle 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 goes on to provide indications of when an investment component and insurance component would be considered highly interrelated.

AASB staff preliminary comments

8.3 AASB staff support this approach in principle, however, sub-paragraph 32(b) introduces a rule that overrides the principle – 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. Staff consider that this condition should only be an indicator that helps elucidate the principle.

8.4 The rule would mean that some contracts in Australia that are currently unbundled into their insurance and investment components would not be able to be unbundled. An example is a product that involves an investment account that is charged with the relevant insurance premiums, and when a client terminates the investment contract element there is no longer an account from which premiums are charged. Accordingly, the whole contract lapses and clients wishing to continue the insurance component are sold a 'new' policy. However, for the duration of the bundled policy, there are two distinct components that are quite capable of being separately recognised based on their natures.

8.5 ED/2013/7 paragraph B25 includes a further rule that compounds the problem caused by the rule in sub-paragraph B32(b). The further rule states: a contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished. That would mean a contract that is regarded as an insurance contract at inception must always be treated as an insurance contract, even though there are products that at inception are substantially insurance contracts which, over time, become substantially investment contracts. Staff consider that the proposals have the potential to seriously distort the financial statements of insurers by requiring investment components of contracts to be treated as insurance contracts.

8.6 The distortion might be revealed in a reconciliation to segment disclosures (required by paragraph 28 of AASB 8 *Operating Segments*) because Australian insurers that sell bundled products generally unbundle them into their insurance segments and wealth segments for management information purposes. However, staff consider that it is inappropriate to have potentially misleading accounting in the primary financial statements and then have to effectively correct the picture provided through segment disclosure.