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Australian Accounting Standards Board

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14 July 2014

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
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UNITED KINGDOM

Dear Hans

IASB Tentative Decision – Insurance Contracts
Recognition of Contractual Service Margin

The AASB has asked me to write to you concerning the tentative decision made by the IASB (published in the May 2014 *IASB Update*) in relation to ED/2013/7 *Insurance Contracts*.

The AASB supports the IASB's tentative decision, in respect of non-participating contracts, to confirm the principle in ED/2013/7 that an entity should recognise the remaining contractual service margin (CSM) in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of services provided under an insurance contract.

However, the AASB has concerns about the tentative decision to clarify that, for contracts with no participating features, the service represented by the CSM is insurance coverage that:

(i) is provided on the basis of the passage of time; and

(ii) reflects the expected number of contracts in force.

The AASB has three key concerns about the IASB's decision to use coverage period for allocating CSM for non-participating business.

1 Allocation should be on a 'stand-ready basis'

The AASB is of the view that the CSM should be allocated based on the pattern of meeting a stand-ready obligation because the service being provided is standing ready to meet claims. In some types of insurance contracts, for example, Lenders Mortgage Insurance (LMI), the service is typically non-linear and applying the IASB's tentative decision would not permit recognition of the CSM in a representationally faithful manner.

Whilst it may be appropriate to include a rebuttable presumption that the service represented by the CSM is allocated based on the passage of time, that presumption should be overridden when a different pattern of allocation would better reflect the pattern of service provision. The AASB considers that, in many cases, using the value of expected claims to determine a 'stand ready obligation' pattern of CSM allocation would better address the issue. The value of expected claims approach would also automatically take account of the expected number of contracts and claims in force.

In addition, the value of expected claims approach would mean that only relative CSM rather than absolute CSM needs to be considered for aggregation purposes when releasing the CSM, which would significantly reduce the number of cohorts of contracts that might otherwise need to be maintained.

The AASB notes an analogy with the principles-based approach in IAS 16 *Property, Plant and Equipment* for allocating depreciation of an asset over its useful life. The AASB would also favour requiring an entity to apply the method of allocation consistently from period to period unless there is a change in the expected pattern of service, similar to the restriction in paragraph 62 of IAS 16 for changing depreciation method.

2 Consistency with the Premium Allocation Approach (PAA)

It is our understanding that the PAA is intended to be a simplification of the full model (the building block approach 'BBA') that is available when it would provide a reasonable approximation of the of the BBA. ED/2013/7 also proposed allowing the use of the PAA for contracts with coverage periods of a year or less (paragraph 35).

When an entity applies the PAA, it does not use fulfilment cash flows and CSM to determine the liability for the remaining coverage. Instead the entity uses a simplified approach that takes into account amounts recognised as insurance contract revenue for coverage that was provided in the period (ED/2013/7 paragraph 38). For the PAA, insurance contract revenue for the period is determined as the amount of the expected premium receipts allocated in the period. The entity allocates the expected premium receipts as insurance contract revenue to each accounting period in a systematic way that best reflects the transfer of services that are provided under the contract (ED/2013/7 paragraph B91).

As the PAA does not specify allocation on the basis of the passage of time, in our view, arbitrarily requiring allocation of CSM based on the passage of time under the BBA would generally have the perverse outcome of precluding non-linear insurance contracts of greater than one year, such as LMI, from being accounted for using the PAA, in circumstances where such contracts could be accounted for in a representationally faithful manner using the PAA.

3 Additional costs for insurers

The AASB is aware that allocation on the basis of the passage of time is not a calculation currently performed by insurers on many classes of business. It would appear to be an arbitrary allocation with potentially little meaning and therefore likely to be of no informational value to users or those managing the insurance business. Accordingly, insurance entities may be required to incur additional costs to achieve what will sometimes be a sub-optimal financial reporting outcome.

The AASB recommends that the IASB reconsiders this tentative decision at a later stage in its redeliberations to take into account the points raised above.

If you have any questions on the comments above, please contact me or Sue Lightfoot (slightfoot@aasb.gov.au).

Yours sincerely

Angus Thomson
Acting Chair