Australian Government
Australian Accounting Standards Board

Memorandum

To:	**AASB members**	**Date:**	19 August 2014
From:	**Sue Lightfoot**	**Agenda Item:**	12.1 (M140)
Subject:	**Insurance Contracts: Consider Key Issues**	**File:**	

Action

Consider key issues arising from recent IASB meetings on its Insurance Contracts project, and decide whether there are any issues that need to be raised with the IASB at this stage.

Attachments

Agenda Paper 12.2 Appendix to Agenda Paper 12.1: Previous IASB redeliberations on ED/2013/7 *Insurance Contracts* (AASB ED 244) (information only).

Agenda Paper 12.3 Letter of reply from IASB dated 24 July 2014 re: Recognition of Contractual Service Margin

Background

In November 2010, the AASB issued ED 201 *Insurance Contracts*, which incorporated the IASB's exposure draft, ED/2010/8 *Insurance Contracts*. The comment period for IASB's ED/2010/8 closed on 30 November 2010 (the comment period for AASB ED 201 closed on 8 November 2010 and attracted 17 submissions).

The AASB submission to the IASB on ED/2010/8, dated 2 December 2010, can be located on the AASB website here.

At AASB meetings held since 2010, AASB staff provided regular updates on the project incorporating tentative decisions made by the IASB.

The IASB subsequently decided to re-expose revised proposals. In June 2013, the AASB issued ED 244 *Insurance Contracts*, which incorporated the IASB's revised exposure draft, ED/2013/7 *Insurance Contracts*. The comment period for IASB's ED/2013/7 closed on 25 October 2013 and 194 comment letters were received (the comment period for AASB ED 244 closed on 27 September 2013 and attracted 12 submissions).

The revised ED sought input on five areas for which the IASB made significant changes in response to the feedback it received on its proposals in the 2010 Exposure Draft, as follows:

a) Adjusting the contractual service margin (CSM);

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

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c) Presentation of insurance contract revenue and expense;

d) Interest expense in profit or loss; and

e) Effective date and transition.

The AASB submission to the IASB, dated 31 October 2013, can be located on the AASB website here.

IASB Redeliberations on ED/2013/7

The IASB began redeliberations on ED/2013/7 in January 2014 and began making tentative decisions at its March 2014 meeting. An analysis of the tentative decisions made by the IASB on ED/2013/7 in its July 2014 meeting is given below. Comments and analysis regarding the March, April, May and June meetings are provided again for information purposes in the Appendix (agenda paper 12.2) to this memo.

As at the date of this memo, the IASB's tentative decisions are only in relation to contracts with no participating features. The IASB has indicated that its tentative decisions may be revisited at a later stage as a result of its consideration of participating contracts.

Correspondence with IASB re Recognition of CSM

In its May meeting the AASB indicated its concern about the IASB's tentative decision to clarify that the service represented by the CSM is insurance coverage that is provided on the basis of the passage of time and reflects the number of contracts in force. The Board expressed the view that the IASB's tentative decision to use coverage period for allocating CSM (for non-participating businesses) has three flaws or weaknesses:

a) the allocation would not reflect a pattern of meeting a stand-ready obligation (for example, for Lenders Mortgage Insurance where the service is typically non-linear);

b) the allocation would be inconsistent with the outcome under the simplified premium allocation approach; and

c) insurers do not currently perform this calculation.

The concern was raised with the IASB and IASB staff at the Accounting Standards Advisory Forum (ASAF) on 2 June 2014 and a follow up letter dated 14 July was sent to the IASB.

A response dated 24 July 2014 (agenda paper 12.3) was received from the IASB Chairman. The letter confirms the IASB's support for its tentative decision, however indicates that the IASB is investigating concerns about application of the decision to contracts where the CSM is high relative to the risk adjustment and coverage extends well beyond the period in which significant risk remains. The letter goes on to indicate that the IASB intends to discuss the allocation of the premium under the PAA in its September meeting.

In response to the AASB's letter concerning costs to insurers, the IASB letter indicates that they do not expect straight-line allocation of CSM to add significant costs and that whatever method is applied new systems and processes will be required. Staff continue have concerns about this issue and will monitor the IASB's developments in this area.

July 2014 (pages 4-5)

The IASB met on 22 July 2014 and, in particular, discussed the following:

- the approach for determining interest expense in profit or loss for participating contracts[1] (education session – no tentative decisions made)
- the rate used to accrete interest and calculate the present value of cash flows that offset the CSM; and
- the restrictions on changes in accounting policy relating to the presentation of the effect of changes in discount rates.

The tentative decisions are analysed in the table below (pages 4-5).

Next steps

The IASB will continue its redeliberations at its September meeting. Insurance Contracts is an agenda item for the September ASAF meeting on 25-26 September and the interim AOSSG meeting on 28 September 2014.

Staff expect that redeliberations of the proposals will be completed in 2014, with the publication of a final IFRS in 2015.

Staff recommendation

Staff recommend raising the concern about the tentative decisions to use 'locked in' rates (for disclosure and interest rate accretion) with the IASB. Staff recommend raising the concern with the IASB and IASB staff at the ASAF meeting in September.

Staff will continue to monitor the project.

Question to Board members:
Does the Board agree with the staff recommendation?

1 The IASB continued its discussions on contracts with participating features. As well as considering the book yield approach for determining the interest expense presented in profit or loss, the IASB would also consider a second approach where:

a. the discount rate for the presentation of interest expense in profit or loss should be reset for *all* the cash flows in the contract whenever there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders (ie. cash flows that vary with returns on underlying items). That approach would apply when the cash flows that vary with underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract. Resetting the discount rate for all cash flows would replace the proposal in the 2013 Exposure Draft *Insurance Contracts* (2013 ED) for the presentation of interest expense in profit or loss, which would require the entity to split the cash flows and apply applicable discount rates to those cash flows; and
b. the discount rate used for the presentation of interest expense in profit or loss should be determined using an approach similar to the effective interest method. This method would replace the 2013 proposal to lock in the yield curve.

This approach could be applied to all contracts with participating features or, if there is a book yield approach, to contracts that do not meet the specified criteria to apply the book yield approach.

IASB July 2014 Tentative Decisions on Insurance Contracts (concerning non-participating contracts only)

IASB Tentative Decisions	Comment from AASB Submission to IASB (emphasis added in bold)	AASB staff comment
July 2014		
Rate used to accrete interest and calculate the present value of cash flows that is offset against CSM		
The IASB tentatively confirmed the proposal in the 2013 ED that, for contracts without participating features, an entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the CSM.	No specific comment in the AASB submission – however the following comments were made in the AASB letter (dated 17 April 2014) to the IASB expressing concern about disclosures driven off locked-in rates: …the AASB has concerns about the tentative decision to require an entity to disclose the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the contractual service margin when measured at current rates, for all portfolios of insurance contracts. The AASB considers this decision would be a major barrier to progress on a comprehensive IFRS on insurance contracts due to the operational problems it raises and for conceptual reasons. … from an operational perspective, entities would need to track the discount rate from inception of insurance contracts to determine the amount(s) to be disclosed to meet this requirement. Systems and processes would therefore need to be in place to	Staff continue to be concerned about the tentative decisions to require entities to track rates at inception of contracts. The concerns are consistent with those outlined in the 17 April 2014 letter to the IASB.

IASB Tentative Decisions	Comment from AASB Submission to IASB (emphasis added in bold)	AASB staff comment
	identify and track discount rates from contract inception for the life of a policy or claims liability, which could be up to 60 years. To do this, entities would need to adopt arbitrary units of account (cohorts of policies) to track discount rates to make systems costs manageable. Insurers are likely to have hundreds, and possibly tens of thousands, of cohorts of contracts to track and different entities are likely to come to different pragmatic solutions that are hardly conducive to comparability. I note that a considerable number respondents to ED/2013/7 raised these operational issues.	
Changes in accounting policy		
The IASB tentatively decided that an entity should apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to changes in accounting policy relating to the presentation of the effect of changes in discount rates.	No specific comment in the AASB submission – the tentative decision relates to the tentative decision (in March 2014) to permit an accounting policy choice which was not contemplated in the IASB 2010 or 2013 EDs.	Staff consider that the tentative decision is reasonable and has the advantage of not creating new requirements specifically for insurance contract accounting.