AASB Exposure Draft

ED 201
August 2010

Insurance Contracts

Comments to AASB by 8 November 2010

Australian Government

Australian Accounting Standards Board

Commenting on this AASB Exposure Draft

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 8 November 2010. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 30 November 2010. Comments should be addressed to:

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Respondents to the IASB are asked to send their comments electronically through the 'Open to Comment' page on the IASB website (www.iasb.org)

All submissions on possible, proposed or existing financial reporting requirements, or on the standard-setting process, will be placed on the public record unless the Chairman of the AASB agrees to those submissions being treated as confidential. The latter will only occur if the public interest warrants such treatment.

Obtaining a Copy of this AASB Exposure Draft

This AASB Exposure Draft is available on the AASB website: www.aasb.gov.au. Alternatively, printed copies of this AASB Exposure Draft are available by contacting:

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PREFACE

EXPOSURE DRAFT ED/2010/8 *INSURANCE CONTRACTS*

PREFACE

Background

Australian Financial Reporting Requirements for Insurance Contracts

AASB 4 *Insurance Contracts* was issued by the Australian Accounting Standards Board (AASB) in 2004 and incorporates IFRS 4 *Insurance Contracts*, which provides minimum requirements regarding the accounting for insurance contracts. Consistent with IFRS 4, the AASB substantively retained its domestic reporting requirements in relation to general (non-life) and life insurance activities, amended to incorporate improvements to accounting for insurance contracts required by IFRS 4. Accordingly, Australian entities currently account for insurance contracts under the following accounting standards:

(a) AASB 1023 *General Insurance Contracts* – which applies to all general (non-life) insurance contracts (including general reinsurance contracts) as well as certain aspects of accounting for assets backing general insurance liabilities;

(b) AASB 1038 *Life Insurance Contracts* – which applies to all life insurance contracts (including life reinsurance contracts), financial instruments with discretionary participation features, certain aspects of accounting for life investment contracts and certain aspects of accounting for assets backing life insurance liabilities or life investment contracts; and

(c) AASB 4 – which generally applies to fee-for-service contracts, such as some roadside assistance service contracts.

Implications for AASB 1023 and AASB 1038 of a Proposed Replacement Standard for IFRS 4

Exposure Draft ED/2010/8 *Insurance Contracts* issued by the International Accounting Standards Board (IASB) proposes that IFRS 4 be replaced with an accounting standard that deals with general (non-life) and life insurance liabilities under the same model. Accordingly, the proposed replacement Standard for IFRS 4 as an Australian Accounting Standard would replace AASB 4, AASB 1023 and AASB 1038.

Main Features of ED/2010/8

ED/2010/8 proposes a comprehensive measurement approach for all types of insurance contracts issued by insurers (and reinsurance contracts held by reinsurers), with a modified approach for some short-duration insurance contracts.

Under the proposals in ED/2010/8, an insurance contract other than a short-duration contract would be measured on the basis of the obligations and rights under the contract using the following 'building blocks':

(a) a current estimate of the future cash flows;

(b) a discount rate that adjusts those cash flows for the time value of money;

(c) an explicit risk adjustment; and

(d) a residual margin.

For short-duration insurance contracts, a modified version of the comprehensive measurement approach would involve an entity applying:

(a) a premium deferral model for pre-claims liabilities ('stand ready' obligations to meet valid claims for insured events that have not yet occurred); and

(b) the 'building block' approach for claims liabilities (obligations to meet valid claims for insured events that have occurred).

The Proposals in ED/2010/8 Compared with AASB 1023 and AASB 1038

In many respects, the proposals in ED/2010/8 are broadly consistent with the current requirements in AASB 1023 and AASB 1038. There are, however, some key exceptions, including the proposals for:

(a) acquisition costs;

(b) residual margins; and

(c) the extent to which diversification benefits are included in the risk adjustment.

Under AASB 1023, acquisition costs are generally deferred and recognised as assets, and subsequently 'amortised'. AASB 1023 permits such an approach when the costs can be reliably measured and it is probable that they will give rise to premium revenue that will be recognised in the income statement in subsequent reporting periods. In accordance with AASB 1038, insurers generally expense acquisition costs when incurred and recognise a part of the premium as revenue at the inception of an insurance contract to cover the incremental costs of issuing the contract.

ED/2010/8 proposes that an insurer:

(a) include incremental acquisition costs in the present value of future cash flows under the contract; and

(b) recognise all acquisition costs other than incremental acquisition costs as an expense when incurred.

ED/2010/8 defines incremental acquisition costs as the costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs.

Under the proposals in ED/2010/8, an insurer would recognise a residual margin in respect of an insurance contract when the present value of expected premiums exceeds the present value of expected claims and expenses plus an appropriate risk adjustment. This approach ensures that the insurer does not recognise a 'day-one' gain on the inception of an insurance contract. In addition, ED/2010/8 proposes that an insurer recognise any residual margins as income in profit or loss over the coverage period in a systematic way that best reflects the insurer's exposure from providing insurance coverage.

In accordance with AASB 1038, a life insurer recognises a residual margin ('planned margin of revenues over expenses') such that no profit is recognised at the inception of a contract. This is similar to the residual margin proposed in ED/2010/8. In addition, AASB 1038 requires the impact of all changes in assumptions regarding future cash flows to be recognised as adjustments to planned (residual) margins and spread over the remaining contract reporting periods, except for changes in:

(a) the estimated present value of expenses over revenues ('onerous contracts');

(b) any subsequent reversals of (a) above; and

(c) discount rates and related economic assumptions;

which are recognised in profit or loss in the period in which the changes occur.

Under the proposals in ED/2010/8, an insurer would recognise all the impacts of changed assumptions in profit or loss in the period in which the changes occur.

AASB 1023 anticipates that, for some general insurers, the risk margin for their outstanding claims liabilities as a whole may be less than the sum of the individual risk margins for each portfolio of insurance contracts, primarily as a consequence of diversification between the different portfolios. Accordingly, AASB 1023 requires risk margins to be determined on a basis that reflects the insurer's business.

Under the proposals in ED/2010/8, an insurer would estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment would reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effects of diversification between different portfolios.

AASB request for comments

In light of the AASB's policy of incorporating International Financial Reporting Standards (IFRSs) into Australian Accounting Standards, the AASB is inviting comments on:

(a) any of the proposals in the attached IASB Exposure Draft, including the specific questions on the proposals as listed in the Invitation to Comment section of the attached IASB Exposure Draft; and

(b) the 'AASB Specific Matters for Comment' listed below.

Submissions play an important role in the decisions that the AASB will make in regard to a Standard. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

Due Date for Comments to the AASB

Comments should be submitted to the AASB by 8 November 2010. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. Constituents are also strongly encouraged to send their response to the IASB.

AASB Specific Matters for Comment

The AASB would particularly value comments on whether:

(a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

  (i) not-for-profit entities; and

  (ii) public sector entities;

(b) overall, the proposals would result in financial statements that would be useful to users;

(c) the proposals are in the best interests of the Australian and New Zealand economies; and

(d) the proposals would be suitable for accounting for the insurance arrangements of superannuation plans (refer to the next section of this Preface).

Relationship to other AASB Projects

AASB's Comprehensive Review of AAS 25 *Financial Reporting by Superannuation Plans*

The AASB is currently redeliberating the proposals in ED 179 *Superannuation Plans and Approved Deposit Funds* relating to a replacement Standard for AAS 25 *Financial Reporting by Superannuation Plans*. ED 179 deals with various aspects of financial reporting by superannuation plans and approved deposit funds, including accounting for obligations for defined benefit members' accrued benefits.

ED 179 proposes, among other things, that obligations and assets arising from insurance contracts issued by plans should be measured in accordance with the principles and requirements applicable to life insurance contracts under AASB 1038.

In its redeliberations on the insurance proposals in ED 179, the AASB noted that:

(a) plans currently measure any obligations to their defined benefit members arising from the insurance arrangements they provide to such members as a part of the members' accrued benefits figure reported under AAS 25;

(b) defined benefit obligations determined under AASB 119 *Employee Benefits* would incorporate any relevant death and disability benefits;

(c) an obligation to defined benefit members arising from the insurance arrangements a plan provides to its members is likely to be measured at a similar amount under the 'accumulation approach' in AASB 1038 as it would be under the approach in AASB 119 for defined benefit obligations; and

(d) employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans are likely to be excluded from the scope of the replacement Standard for IFRS 4.

Accordingly, the AASB decided that, under a replacement Standard for AAS 25:

(a) any obligations to defined benefit members arising from insurance arrangements provided by a plan should be measured as a part of the plan's obligation for such members' accrued benefits in accordance with the approach in AASB 119 for defined benefit obligations; and

(b) to facilitate consistency with the measurement of insurance obligations in relation to defined benefit members, any obligations to defined contribution members arising from insurance arrangements provided by a plan should be measured in accordance with the approach in AASB 119 for defined benefit obligations.

In addition, the AASB decided that, in light of the IASB's active project on insurance contracts, it would reconsider the accounting for insurance contracts by superannuation entities once the IASB has finalised its thinking on insurance contracts.

Reduced Disclosure Requirements

In June 2010, the AASB published AASB 1053 *Application of Tiers of Australian Accounting Standards*. AASB 1053 establishes a differential reporting framework consisting of two Tiers of reporting requirements for preparing general purpose financial statements:

(a) Tier 1: Australian Accounting Standards; and

(b) Tier 2: Australian Accounting Standards – Reduced Disclosure Requirements.

Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1 and substantially reduced disclosures corresponding to those requirements.

AASB 4, AASB 1023 and AASB 1038 were excluded from the scope of ED 192 *Revised Differential Reporting Framework* (the Exposure Draft proposing the differential reporting framework in AASB 1053) on the grounds that an entity that applies any or all of these Standards would generally be a publicly accountable entity and therefore required to prepare Tier 1 general purpose financial statements.

In its redeliberations on the proposals in ED 192, the AASB noted that some respondents questioned whether 'captive' insurers should be classified as publicly accountable since, in their view, there is unlikely to be a broad group of outsiders involved. The AASB also noted that the nature of captive insurers varies. Some only provide insurance to subsidiaries within their group while others also insure joint venture businesses. Some captive insurers, such as associative captive insurers, can insure a wide range of members. Those that provide insurance to subsidiaries within groups may also deal with outsiders.

In light of respondents' comments, the AASB concluded that, whilst it expects that most insurance companies will be publicly accountable, there may be certain general insurers, such as captive insurers, that may not be publicly accountable.

The AASB plans to issue a supplementary Exposure Draft outlining proposals for reduced disclosure requirements in respect of the disclosure proposals in ED/2010/8.

July 2010

Exposure Draft ED/2010/8

Insurance Contracts

Comments to be received by 30 November 2010

Exposure Draft
Insurance Contracts

Comments to be received by 30 November 2010

ED/2010/8

This exposure draft *Insurance Contracts* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as an International Financial Reporting Standard (IFRS). Comments on the exposure draft and the Basis for Conclusions should be submitted in writing so as to be received by **30 November 2010.** Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

The IASB, the IFRS Foundation, the authors and the publishers do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

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INTRODUCTION AND INVITATION TO COMMENT

Introduction

Reasons for publishing the exposure draft

IN1 The International Accounting Standards Board (the Board or IASB) has published the exposure draft *Insurance Contracts* to propose significant improvements to the accounting for insurance contracts. Such improvements are needed urgently. Many users of financial statements describe insurance accounting today as a 'black box' that does not provide them with relevant information about an insurer's financial position and financial performance.

IN2 The proposals in the exposure draft, if confirmed, would:

(a) provide a comprehensive framework that will require insurers to provide information that is relevant to users of financial statements for economic decision-making.

(b) eliminate inconsistencies and weaknesses in existing practices, by replacing IFRS 4 *Insurance Contracts*. IFRS 4 is an interim standard that allows insurers to continue using various existing accounting practices that have developed in a piecemeal fashion over many years.

(c) provide comparability across entities, jurisdictions and capital markets.

Main features of the exposure draft

IN3 The exposure draft proposes a comprehensive measurement approach for all types of insurance contracts issued by entities (and reinsurance contracts held by entities), with a modified approach for some short-duration contracts. The approach is based on the principle that insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows (premiums) and outflows (benefits and claims). An insurer would apply to that package of cash flows a measurement approach that uses the following building blocks:

(a) a current estimate of the future cash flows

(b) a discount rate that adjusts those cash flows for the time value of money

(c) an explicit risk adjustment

(d) a residual margin.

IN4 For most short-duration contracts, a modified version of the measurement approach would apply:

(a) During the coverage period, the insurer would measure the contract using an allocation of the premium received, on a basis largely similar to much existing practice.

(b) The insurer would use the building block approach to measure claims liabilities for insured events that have already occurred.

Development of the proposals

IN5 The proposals in the exposure draft are the result of extensive deliberations following the publication of a discussion paper *Preliminary Views on Insurance Contracts* in May 2007, consultations with the IASB's Insurance Working Group (IWG) and input from participants in a targeted field test in late 2009.

IN6 The Board developed the proposals jointly with the US Financial Accounting Standards Board (FASB). The boards reached the same conclusions in many areas, but reached different conclusions in areas summarised in the invitation to comment that follows and in the appendix to the Basis for Conclusions. The FASB plans to publish a discussion paper to seek additional input from constituents. That discussion paper would present the IASB's proposals, the FASB's tentative decisions, and a comparison of each of those models with existing US generally accepted accounting principles (GAAP).

Invitation to comment

IN7 The Board invites comments on any aspect of the exposure draft of its proposed IFRS *Insurance Contracts*. It would particularly welcome answers to the questions set out below. Comments are most helpful if they:

(a) respond to the questions as stated,

(b) indicate the specific paragraph or paragraphs to which the comments relate,

(c) contain a clear rationale, and

(d) describe any other approaches the Board should consider, if applicable.

IN8 Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.

IN9 The Board will consider all comments received in writing by **30 November 2010**. In considering the comments, the Board will base its conclusions on the merits of the arguments for and against each approach, not on the number of responses supporting each approach.

Measurement (paragraphs 16–61, B34–B110 and BC45–BC155)

Measurement model (paragraphs 16–53 and BC45–BC144)

IN10 The exposure draft proposes a measurement model for all types of insurance (and reinsurance) contracts that, except for modification for short-duration contracts (see paragraph IN15), uses:

(a) a direct measurement that incorporates current, discounted estimates of future cash flows revised at each reporting date, adjusted for the effects of uncertainty about the amount and timing of those future cash flows (ie a risk adjustment); and

(b) a margin that reports profitability of the contracts over their coverage period (ie a residual margin).

IN11 The risk adjustment represents the maximum amount that an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. It is remeasured at the end of each reporting period and declines over time as the insurer is released from risk.

IN12 The residual margin is calibrated at inception to an amount that means the insurer recognises no gain on entering into an insurance contract. The residual margin is released over the coverage period in a systematic manner based on the passage of time, unless the pattern of claims and benefits makes another pattern more appropriate.

IN13 For US GAAP, the FASB reached a different conclusion. The FASB concluded that the model should not include a separate risk adjustment and residual margin, but should instead combine these in a single composite margin. The composite margin is released over both the coverage period and the claims handling period on the basis of the insurer's exposure from the provision of insurance coverage, and the insurer's exposure from uncertainties associated with future cash flows.

IN14 Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract (ie acquisition costs). The exposure draft requires an insurer:

(a) to include incremental acquisition costs for contracts actually issued in the initial measurement as part of the contract cash flows. As a result, those costs affect profit over the coverage period, rather than at inception.

(b) to recognise all other acquisition costs as an expense when incurred.

Question 1 – Relevant information for users (paragraphs BC13–BC50)

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)

(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

Short-duration contracts (paragraphs 54–60 and BC145–BC148)

IN15 A premium allocation model is proposed as a modified measurement for the pre-claims liabilities of some short-duration insurance contracts (unless the contract is onerous).

Question 8 – Premium allocation approach

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

Cash flows that arise from future premiums (paragraphs 26–29 and BC53–BC66)

IN16 To identify the future cash flows that are expected to arise as the insurer fulfils the obligation, it is necessary to determine whether future premiums (and resulting benefits and claims) arise from:

(a) existing contracts (included in the liability measurement) or

(b) future contracts (not included in the measurement).

IN17 To achieve this distinction, paragraph 27 of the exposure draft proposes that the boundary of an insurance contract would be the point at which an insurer either:

(a) is no longer required to provide coverage, or

(b) has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk.

Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

Participating features (paragraphs 23, 62–66, BC67–BC75 and BC198–BC203)

IN18 Some insurance contracts provide policyholders with a right to participate in the favourable performance of a specified class of contracts, related assets or both (ie a participating feature). The exposure draft proposes that payments arising from the participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash outflows (ie on an expected present value basis).

IN19 Some insurers issue financial instruments with discretionary participation features similar to those found in some participating insurance contracts. The Board proposes to include these contracts within the scope of the IFRS, if specified conditions are met. For US GAAP, the FASB has tentatively decided to include these contracts within the scope of its financial instruments standards.

Question 10 – Participating features

(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?

(b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?

(c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

Definition and scope (paragraphs 2–7, B2–B33 and BC188–BC209)

IN20 The proposed definition of an insurance contract is based on the transfer of significant insurance risk to the insurer, used in IFRS 4. Appendix B provides guidance on the definition. The scope exclusions are listed in paragraph 4 of the exposure draft.

Question 11 – Definition and scope

(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?

(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

Unbundling (paragraphs 8–12 and BC210–BC225)

IN21 The exposure draft proposes that an insurer should account for investment (ie financial) and service components separately from the insurance component (ie unbundling) when there is:

(a) an investment component reflecting an account balance that meets specified criteria;

(b) an embedded derivative that is separated from its host in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*; and

(c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

Presentation (paragraphs 69–78 and BC150–BC183)

IN22 The exposure draft proposes a presentation of the statement of comprehensive income that will help users of an insurer's financial statements understand important performance factors; such information is lacking under many existing models, particularly for life contracts. The presentation also fits together naturally with the proposed measurement approach for insurance contracts. The proposed presentation would achieve this by presenting income and expense in a manner that highlights:

(a) the underwriting margin (ie changes in the risk adjustment and release of the residual margin);

(b) experience adjustments (ie differences between actual cash flows and previous estimates) and changes in estimates (ie changes in current estimates of cash flows and discount rates); and

(c) interest on insurance contract liabilities (presented or disclosed in a way that highlights its relationship with the investment return on assets backing those liabilities).

IN23 An insurer would be required to present all income and expense arising from insurance contracts in profit and loss.

Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

Disclosures (paragraphs 79–97, BC242 and BC243)

IN24 The objective of the proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of cash flows arising from insurance contracts. Specifically, the proposed disclosure principle requires an insurer to explain:

(a) the amounts recognised in the financial statements arising from insurance contracts and

(b) the nature and extent of risks arising from those contracts.

Question 14 – Disclosures

(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

Unit-linked contracts (paragraphs 8(a)(i), 71 and 78, Appendix C, and paragraphs BC153–BC155 and BC184–BC187)

IN25 For unit-linked contracts (sometimes known as variable contracts), the exposure draft proposes that, for assets for which existing requirements result in an accounting mismatch, an insurer should recognise the underlying assets and measure them at fair value through profit or loss. With respect to those assets, this proposal would require consequential amendments to:

(a) IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*, to address shares issued by the insurer.

(b) IAS 16 *Property, Plant and Equipment*, to address property occupied by the insurer.

IN26 In addition:

(a) the proposals on unbundling (see paragraph IN21) are relevant for unit-linked contracts.

(b) the exposure draft proposes presentation requirements for unit-linked contracts and related assets.

Question 15 – Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

Reinsurance (paragraphs 43–46 and BC230–BC241)

IN27 The proposals in the exposure draft would also apply to the reinsurance contracts that an insurer holds. The Board has identified no reason for different measurement approaches for direct insurance liabilities and reinsurance liabilities.

IN28 A cedant faces the risk that the reinsurer may default. The Board proposes an expected loss model for reinsurance assets. In other words, the measurement of the reinsurance asset would incorporate a reduction for the expected (ie probability-weighted) present value of losses from default or disputes.

Question 16 – Reinsurance

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

(b) Do you have any other comments on the reinsurance proposals?

Transition and effective date (paragraphs 98–102 and BC244–BC257)

IN29 The proposed transition requirements are in paragraphs 98–102. As noted in the Basis for Conclusions on IFRS 9, the Board will consider delaying the effective date of IFRS 9 if the IFRS on insurance contracts has a mandatory effective date later than 1 January 2013.

Question 17 – Transition and effective date

(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

Other comments

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

Benefits and costs (paragraphs BC258–BC263)

IN30 When the Board develops an IFRS it assesses whether the overall benefits of improved financial information justify the costs of providing it.

> **Question 19 – Benefits and costs**
>
> Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

[Draft] International Financial Reporting Standard X *Insurance Contracts* ([draft] IFRS X) is set out in paragraphs 1–102 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[Draft] International Financial Reporting Standard X *Insurance Contracts*

Objective

1 The objective of this [draft] IFRS is to establish the principles that an entity should apply to report useful information to users of its financial statements about the amount, timing and uncertainty of cash flows from:

(a) *insurance contracts* that it issues,

(b) *reinsurance contracts* that it holds, and

(c) financial instruments containing *discretionary participation features* that it issues.

Scope

2 An entity shall apply this [draft] IFRS to:

(a) insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.

(b) financial instruments that it issues containing a discretionary participation feature (see paragraphs 62–66).

3 This [draft] IFRS does not address other aspects of accounting by insurers, such as accounting for their financial assets and financial liabilities, other than those mentioned in paragraph 2(b) (see IFRS 9 *Financial Instruments,* IFRS 7 *Financial Instruments: Disclosures,* IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*), except in the transition requirements in paragraph 102.

4 An entity shall not apply this [draft] IFRS to:

(a) product warranties issued by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

(b) employers' assets and liabilities under employee benefit plans (see IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).

(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (eg some licence fees, royalties, contingent lease payments and similar items, see IAS 17 *Leases,* IAS 18 and IAS 38 *Intangible Assets*).

(d) residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 and IAS 18).

(e) fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event, for example maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction (see IAS 18). However, an insurer shall apply this [draft] IFRS to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.

(f) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).

(g) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the *policyholder*). However, a *cedant* shall apply this [draft] IFRS to reinsurance contracts that it holds.

5 For ease of reference, this [draft] IFRS describes any entity that issues an insurance contract as an *insurer*, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.

6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to reinsurance contracts.

7 Appendix B provides guidance on the definition of an insurance contract (see paragraphs B2–B33).

Unbundling

8 Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, for example an investment (financial) component or a service component. If a component is not closely related to the insurance coverage specified in a

contract, an insurer shall apply that other IFRS to account for that component as if it were a separate contract (ie shall *unbundle* that component). The following are the most common examples of components that are not closely related to the insurance coverage:

(a) an investment component reflecting an account balance that meets both of the following conditions:

  (i) the account balance is credited with an explicit return (ie it is not an implicit account balance, for example derived by discounting an explicit maturity value at a rate not explicitly stated in the contract); and

  (ii) the crediting rate for the account balance is based on the investment performance of the underlying investments, namely a specified pool of investments for unit-linked contracts, a notional pool of investments for index-linked contracts or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments. Contracts meeting those criteria can specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would mean that not all investment performance is passed through to the contract holder.

(b) an embedded derivative that is separated from its host contract in accordance with IAS 39 (see paragraph 12 below).

(c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

9 In unbundling an account balance specified in paragraph 8(a), an insurer shall regard all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, as belonging to either the insurance component or another component, but are not part of the investment component. Thus, the crediting rate used in determining that account balance reflects a crediting rate after eliminating any cross-subsidy between that rate and the charges or fees assessed against the account balance.

10 An insurer shall not unbundle components of a contract that are closely related to the insurance coverage specified in the insurance contract.

11 Throughout this [draft] IFRS, the term *insurance contract* refers to the components of an insurance contract that remain after unbundling any components in accordance with paragraph 8.

Embedded derivatives

12 IAS 39 applies to a derivative embedded in an insurance contract unless the embedded derivative is itself an insurance contract. IAS 39 requires an entity to separate an embedded derivative from its host contract, measure it at fair value and recognise changes in its fair value in profit or loss, if the embedded derivative meets both of the following criteria:

(a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host insurance contract (see paragraphs AG30–AG33 of IAS 39). The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host insurance contract if, for example, the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately, ie without considering the host contract (see paragraph AG33(h) of IAS 39).

(b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative and be within the scope of IAS 39 (eg the derivative itself is not an insurance contract).

Recognition

13 An insurer shall recognise an *insurance contract liability* or an *insurance contract asset* when the insurer becomes a party to the insurance contract.

14 An insurer becomes a party to an insurance contract on the earlier of the following two dates:

(a) when the insurer is bound by the terms of the insurance contract, and

(b) when the insurer is first exposed to risk under the contract, which is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk.

15 An insurer shall not recognise as a liability or an asset any amounts relating to possible claims under future insurance contracts (such as the amounts described in some jurisdictions as catastrophe provisions or equalisation provisions). This [draft] IFRS does not prohibit an entity from presenting such amounts by appropriating retained earnings to reserves within equity. IAS 1 *Presentation of Financial Statements* requires an entity to describe the nature and purpose of each reserve within equity.

Measurement

16 Paragraphs 17–53 describe the measurement model that an insurer shall apply to all insurance contracts, except some short-duration contracts specified in paragraph 54, for which paragraphs 55–60 describe a modified version of that model.

Initial measurement

17 An insurer shall measure an insurance contract initially at the sum of:

(a) the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, adjusted for the effects of uncertainty about the amount and timing of those future cash flows (*present value of the fulfilment cash flows*, see paragraph 22); and

(b) a *residual margin* that eliminates any gain at inception of the contract. A residual margin arises when the amount in (a) is less than zero (ie when the expected present value of the future cash outflows plus the *risk adjustment* is less than the expected present value of the future cash inflows).

18 If the present value of the fulfilment cash flows specified in paragraph 17(a) is greater than zero (ie the expected present value of the future cash outflows plus the risk adjustment exceeds the expected present value of the future cash inflows), the insurer shall immediately recognise that amount in profit or loss as an expense.

19 It follows from paragraphs 17 and 18 that the measurement of an insurance contract at initial recognition is:

(a) zero, if the present value of the fulfilment cash flows is zero or less.

(b) the present value of the fulfilment cash flows, if that present value is greater than zero.

20 An insurer shall determine the residual margin in paragraph 17(b) at a level that aggregates insurance contracts into a *portfolio of insurance contracts* and, within a portfolio, by similar date of inception of the contract and by similar *coverage period*.

21 An insurer can become a party to an insurance contract before the coverage period starts. In many cases, the measurement of insurance contracts does not change materially after initial recognition before the start of the coverage period. During that time, the measurement of the insurance contract is updated only for cash received or paid, the accretion of interest, and changes in estimates of cash flows and discount rates. An insurer shall start recognising the residual margin in profit or loss only once the coverage period begins (see paragraph 50).

Present value of the fulfilment cash flows

22 The following building blocks constitute the present value of the fulfilment cash flows:

(a) an explicit, unbiased and probability-weighted estimate (ie expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract (paragraphs 23–25);

(b) a discount rate that adjusts those cash flows for the time value of money (paragraphs 30–34); and

(c) an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows (risk adjustment—paragraphs 35–37).

Future cash flows

23 Estimates of cash flows for a portfolio of insurance contracts shall include all incremental cash inflows and cash outflows arising from that portfolio, and shall:

(a) be explicit (ie separate from estimates of discount rates that adjust those cash flows for the time value of money and the risk adjustment that adjusts those cash flows for the effects of uncertainty about the amount and timing of those future cash flows).

(b) reflect the perspective of the entity but, for market variables, be consistent with observable market prices.

(c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows that will arise as the insurer fulfils the insurance contract.

(d) be current (ie the estimates shall reflect all available information at the measurement date).

(e) include only those cash flows that arise from existing contracts (ie cash inflows and cash outflows that arise within the boundary of those contracts—see paragraphs 26 and 27).

24 At initial recognition, an insurer shall include in the measurement of the insurance contract an estimate of all cash flows that will arise as the insurer fulfils the insurance contract over the life of that contract. Some of those cash flows are received or paid on the day the insurance contract is initially recognised, for example initial premiums and some incremental acquisition costs (see paragraph 39(a)). Those cash flows result in a change in the carrying amount of the insurance contract liability on the day the insurance contract is initially recognised, but immediately after the moment of initial recognition.

25 Appendix B provides guidance for estimating future cash flows (see paragraphs B37–B66).

Contract boundary

26 The measurement of an insurance contract shall include premiums and other cash flows (eg claims and expenses) resulting from those premiums if, and only if:

(a) the insurer can compel the policyholder to pay the premiums, or

(b) the premiums are within the boundary of that contract.

27 The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts. The boundary of an insurance contract is the point at which an insurer either:

(a) is no longer required to provide coverage, or

(b) has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract).

28 Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the benefits they will receive. Such features include surrender options, conversion options and options to cease paying premiums but still receive some benefits. The measurement of insurance contracts shall reflect the future behaviour of policyholders on an expected value basis, with an adjustment for the risk that the actual behaviour of the policyholder may differ from the expected behaviour. For example, the measurement of an insurance contract:

(a) shall not assume that all policyholders surrender their contracts only because surrender would be unfavourable to the insurer.

(b) shall not assume that all policyholders continue their contracts only because continuation would be unfavourable to the insurer.

29 If options, forwards and guarantees do not relate to the insurance coverage under the existing insurance contract, they are not within the boundary of that contract. The insurer shall account for those features as new insurance contracts or other stand-alone instruments according to their nature.

Time value of money

30 An insurer shall adjust the future cash flows for the time value of money, using discount rates that:

(a) are consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, in terms of, for example, timing, currency and liquidity.

(b) exclude any factors that influence the observed rates but are not relevant to the insurance contract liability (eg risks not present in the liability but present in the instrument for which the market prices are observed).

31 As a result of the principle in paragraph 30, if the cash flows of an insurance contract do not depend on the performance of specific assets, the discount rate shall reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, with an adjustment for illiquidity (see paragraph 34).

32 If the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence. In some circumstances, the most appropriate way to reflect that linkage might be to use a replicating portfolio technique (see paragraphs B45–B47).

33 Estimates of cash flows and discount rates shall be internally consistent to avoid double-counting or omissions. For example, nominal cash flows (ie those that include the effect of inflation) shall be discounted at rates that include the effect of inflation. Real cash flows (ie those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.

34 Many insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets. For example, some government bonds are traded in deep and liquid markets and the holder can typically sell them readily at any time without incurring significant costs. In contrast, policyholders cannot liquidate their investment in some insurance contract liabilities without incurring significant costs, and in some cases they have no contractual right to liquidate their holding at all. Thus, in estimating discount rates for an insurance contract, an insurer shall take account of any differences between the liquidity characteristics of the instruments underlying the rates observed in the market and the liquidity characteristics of the insurance contract.

Risk adjustment

35 The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.

36 An insurer shall estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment shall reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effects of diversification between that portfolio and other portfolios of insurance contracts.

37 Appendix B provides guidance for estimating the risk adjustment (see paragraphs B67–B103).

Non-performance risk

38 The present value of the fulfilment cash flows shall not reflect the risk of non-performance by the insurer, either at initial recognition or subsequently.

Acquisition costs

39 At initial recognition, an insurer shall:

(a) include *incremental acquisition costs* in the present value of the fulfilment cash flows (see also paragraph B61(f)).

(b) recognise all *acquisition costs* other than those identified in (a) as an expense when incurred.

Insurance contracts acquired in a portfolio transfer or business combination

40 An insurer shall measure a portfolio of insurance contracts acquired in a portfolio transfer at the higher of the following:

(a) the consideration received (after adjusting the consideration for any other assets and liabilities acquired in the same transaction, such as financial assets and customer relationships). The excess of that consideration over the present value of the fulfilment cash flows establishes the residual margin at initial recognition.

(b) the present value of the fulfilment cash flows. If that amount exceeds the consideration received, the insurer shall recognise that excess immediately as an expense.

41 In assessing whether a loss arises when acquiring a portfolio of insurance contracts (see paragraph 40(b)), the insurer shall determine whether it has recognised all of the intangible or other assets acquired in the portfolio transfer, and shall review its measurement of that portfolio at initial recognition.

42 An insurer shall measure a portfolio of insurance contracts acquired in a business combination at the higher of the following:

(a) the fair value of the portfolio. The excess of that fair value over the present value of the fulfilment cash flows establishes the residual margin at initial recognition.

(b) the present value of the fulfilment cash flows. If that amount exceeds the fair value of the portfolio, that excess increases the

initial carrying amount of goodwill recognised in the business combination.

Reinsurance contracts

43 Applying the same principles as those underlying paragraph 17, a cedant shall measure a reinsurance contract at initial recognition as the sum of:

(a) the present value of the fulfilment cash flows (for this purpose the expected present value of the cedant's future cash inflows plus the risk adjustment less the expected present value of the cedant's future cash outflows); and

(b) a residual margin, as described in paragraph 45.

44 The cedant shall estimate the present value of the fulfilment cash flows for the reinsurance contract in the same manner as the corresponding part of the present value of the fulfilment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contract(s) on initial recognition of the reinsurance contract. In addition, the cedant shall consider the risk of non-performance by the reinsurer on an expected value basis when estimating the present value of the fulfilment cash flows.

45 In accordance with paragraph 17, the residual margin cannot be negative. Therefore, if the present value of the fulfilment cash flows for the reinsurance contract is:

(a) less than zero (ie the expected present value of future cash inflows plus the risk adjustment is less than the expected present value of future cash outflows), the cedant shall establish that amount as the residual margin at initial measurement.

(b) greater than zero (ie the expected present value of future cash inflows plus the risk adjustment exceed the expected present value of future cash outflows), the cedant shall recognise that amount as a gain at initial recognition of the reinsurance contract.

46 The cedant shall treat ceding commissions it receives as a reduction of the premium ceded to the reinsurer.

Subsequent measurement

47 The carrying amount of an insurance contract at the end of each reporting period shall be the sum of:

(a) the present value of the fulfilment cash flows at that date, and

(b) the remaining amount of the residual margin.

48 The present value of the fulfilment cash flows shall reflect all available information at the end of the reporting period (ie it shall reflect current estimates of the amount, timing and uncertainty of the remaining future cash flows, current discount rates and a current risk adjustment). An insurer shall review its estimates at that date and update them if evidence indicates that previous estimates are no longer valid. In doing so, an insurer shall consider both of the following:

(a) whether the updated estimates represent faithfully the conditions at the end of the reporting period, and

(b) whether changes in estimates represent faithfully changes in conditions during the period.

49 A cedant shall update the measurement of the present fulfilment cash flows of a reinsurance contract for changes in the risk of non-performance by the reinsurer.

50 An insurer shall recognise the residual margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of the passage of time, but

(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

51 An insurer shall accrete interest on the carrying amount of the residual margin, using the discount rate specified in paragraph 30 as determined at initial recognition.

52 The residual margin shall not be negative. Once the coverage period has ended, the residual margin is zero; hence, after that point the contract shall be measured as the present value of the fulfilment cash flows.

53 If fewer contracts are in force at the end of a period than was expected at the beginning of the period, the amount of the residual margin recognised in profit or loss during the period shall include an adjustment to eliminate from the residual margin at the end of the reporting period the portion relating to contracts that are no longer in force. If more contracts are in force at the end of a period than was expected at the beginning of the period, the insurer shall not increase the residual margin.

Pre-claims liability for short-duration contracts

54 Paragraphs 55–60 apply to insurance contracts that meet both of the following conditions:

(a) The coverage period of the insurance contract is approximately one year or less.

(b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12.

55 For those contracts, an insurer shall:

(a) measure its *pre-claims liability* by allocating premiums over the coverage period as described in paragraphs 56–60.

(b) measure its *claims liability* at the present value of the fulfilment cash flows, in accordance with paragraphs 22–46.

56 The pre-claims liability is the pre-claims obligation (as described in paragraphs 57 and 58), less the expected present value of future premiums, if any, that are within the boundary of the existing contract.

57 For insurance contracts specified in paragraph 54, an insurer shall measure its pre-claims obligation at initial recognition as

(a) the premium, if any, received at initial recognition, plus the expected present value of future premiums, if any, that are within the boundary of the existing contract; less

(b) the incremental acquisition costs.

58 Subsequently, the insurer shall reduce the measurement of the pre-claims obligation over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of the passage of time, but

(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

59 An insurer shall accrete interest on the carrying amount of the pre-claims liability, using the discount rate specified in paragraph 30, updated in each reporting period.

60 An insurance contract is onerous if, at initial recognition or subsequently, the present value of the fulfilment cash flows relating to future insured claims that are within the boundary of an existing contract exceeds the carrying amount of the pre-claims obligation. If a contract is onerous, the insurer shall recognise an additional liability and a corresponding expense, measured as the difference between the carrying amount of the pre-claims obligation and the present value of the fulfilment cash flows. To determine whether insurance contracts are onerous and, if applicable, to measure the amount of the additional liability, the insurer shall aggregate the insurance contracts into a portfolio and, within a portfolio, by similar date of inception. An insurer shall update the measurement of that additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous.

Foreign currency

61 When applying IAS 21 *The Effects of Changes in Foreign Exchange Rates* to an insurance contract that results in cash flows in a foreign currency, the insurer shall treat the contract as a monetary item. This requirement applies not only to the present value of the fulfilment cash flows, but also to the residual margin. That requirement also applies to the pre-claims liability of short-duration contracts measured in accordance with paragraphs 56–60.

Financial instruments that contain discretionary participation features

62 As specified in paragraph 2(b), this [draft] IFRS applies to financial instruments that contain a discretionary participation feature.

63 Such financial instruments do not transfer significant insurance risk. Therefore, some of the requirements in this [draft] IFRS are modified as described in paragraphs 64 and 65 when applied to those financial instruments.

64 Paragraph 27 defines the boundary of an insurance contract. Instead, the boundary of a financial instrument with a discretionary participation feature is the point at which the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract.

65 Paragraph 50 describes the basis for the release of the residual margin. Instead, the residual margin for an financial instrument with a discretionary participation feature shall be recognised as income in profit or loss over the life of the contract in a systematic way that best reflects the asset management services, as follows:

(a) on the basis of the passage of time, but

(b) on the basis of the fair value of assets under management, if that pattern differs significantly from the passage of time.

66 Other requirements of this [draft] IFRS apply equally to a financial instrument with a discretionary participation feature, even though those contracts do not transfer significant insurance risk. For example, the cash flows arising from those financial instruments may be subject to uncertainty as a result of risks other than insurance risk (eg lapse risk and expense risk). If those risks are material, the present value of the fulfilment cash flows shall include a risk adjustment to reflect the risk that the ultimate cash flows may exceed those expected. But because financial instruments with discretionary participation features contracts do not transfer significant insurance risk, the application of some of the requirements in this [draft] IFRS may not be relevant or may not have a material effect.

Derecognition

67 An insurer shall remove an insurance contract liability (or a part of an insurance contract liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the insurance contract is discharged or cancelled or expires. At that point, the insurer is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance obligation.

68 When a cedant buys reinsurance, it shall derecognise the underlying contract or contracts only if that contract or those contracts are extinguished.

Presentation

Statement of financial position

69 An insurer shall present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities.

70 An insurer shall not offset reinsurance assets against insurance contract liabilities.

71 An insurer shall present:

(a) the pool of assets underlying *unit-linked contracts* as a single line item, and not commingle it with the insurer's other assets.

(b) the portion of the liabilities from unit-linked contracts linked to the pool of assets in (a) as a single line item and not commingle it with the insurer's other insurance contract liabilities.

Statement of comprehensive income

72 At a minimum, an insurer shall include for insurance contract line items in its statement of comprehensive income that present the following amounts for the period:

(a) underwriting margin, disaggregated either in the statement of comprehensive income or in the notes into:

(i) the change in risk adjustment.

(ii) the release of residual margin.

(b) gains and losses at initial recognition, disaggregated either in the statement of comprehensive income or in the notes into:

(i) losses on insurance contracts acquired in a portfolio transfer (see paragraph 40(b)).

(ii) gains on reinsurance contracts bought by a cedant (see paragraph 45(b)).

(iii) losses at initial recognition of an insurance contract (see paragraph 18).

(c) acquisition costs that are not incremental at the level of an individual contract (see paragraph 39(b)).

(d) experience adjustments and changes in estimates, disaggregated either in the statement of comprehensive income or in the notes into:

(i) differences between actual cash flows and previous estimates of those cash flows (ie experience adjustments).

(ii) changes in estimates of cash flows and changes in discount rates.

(iii) impairment losses on reinsurance assets.

(e) interest on insurance contract liabilities.

73 The changes in estimates of discount rates and the interest on insurance liabilities shall be presented or disclosed in a way that highlights their relationship with the investment return on the assets backing those liabilities.

74 An insurer shall not present in the statement of comprehensive income, except as noted in paragraph 75(a):

(a) premiums, which instead are treated in the same way as deposit receipts; and

(b) claims expenses, claims handling expenses, incremental acquisition costs and other expenses included in the measurement of the insurance contract, which instead are treated in the same way as repayments of deposits.

75 For some short-duration contracts, the pre-claims liability is measured in accordance with paragraphs 56–60. For those contracts, an insurer shall, in addition to the applicable line items in paragraph 72, include in its statement of comprehensive income line items that present the following amounts from insurance contracts for the period:

(a) the underwriting margin, disaggregated either in the statement of comprehensive income or in the notes into:

(i) premium revenue, determined as the gross release of the pre-claims obligation (ie grossed-up for the amortisation of incremental acquisition costs, see paragraph 57(a)).

(ii) claims incurred.

(iii) expenses incurred.

(iv) amortisation of incremental acquisition costs included in the pre-claims obligation (see paragraph 57(b)).

(b) changes in additional liabilities for onerous contracts (see paragraph 60).

76 An entity shall present all income and expense from insurance contracts in profit or loss.

77 An insurer shall not offset income or expense from reinsurance contracts against the expense or income from insurance contracts.

78 An insurer shall present income and expense from:

(a) unit-linked contracts as a single line item, and not commingle them with income and expense from the insurer's other insurance contract liabilities.

(b) the pool of assets underlying unit-linked contracts as a single line item, and not commingle them with income or expense from the insurer's other assets.

Disclosure

79 To help users of financial statements understand the amount, timing and uncertainty of future cash flows arising from insurance contracts, an insurer shall disclose qualitative and quantitative information about:

(a) the amounts recognised in its financial statements arising from insurance contracts (see paragraphs 85–90); and

(b) the nature and extent of risks arising from insurance contracts (see paragraphs 91–97).

80 If the disclosures required by this [draft] IFRS and other IFRSs do not meet that objective in a particular situation, an insurer shall disclose whatever additional information is necessary to meet that objective.

81 An insurer shall consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of the various requirements. An insurer shall aggregate or disaggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

82 An insurer shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

83 The disclosures required in this [draft] IFRS shall not aggregate information relating to different reportable segments, as defined in IFRS 8 *Operating Segments*.

84 Examples of aggregation levels that might be appropriate are:

(a) type of contract.

(b) geography (eg country or region).

Explanation of recognised amounts

85 An insurer shall disclose information about the amounts recognised in its financial statements in sufficient detail to help users of its financial statements evaluate the timing, amount and uncertainty of future cash flows arising from insurance contracts, including:

(a) reconciliation from the opening to the closing aggregate contract balances (see paragraphs 86–89).

(b) the methods and inputs used to develop the measurements (see paragraph 90).

Reconciliation of contract balances

86 To comply with paragraph 85(a), an insurer shall disclose a reconciliation from the opening to the closing balance of each of the following, if applicable:

(a) insurance contract liabilities and, separately, insurance contract assets.

(b) risk adjustments included in (a).

(c) residual margins included in (a).

(d) reinsurance assets arising from reinsurance contracts held by the insurer as cedant.

(e) risk adjustments included in (d).

(f) residual margins included in (d).

(g) impairment losses on reinsurance assets.

87 For each reconciliation required by paragraph 86, an insurer shall show, at a minimum, each of the following, if applicable:

(a) the carrying amounts at the beginning and end of the period.

(b) new contracts recognised during the period.

(c) premiums received.

(d) payments, with separate disclosure of:

(i) claims and benefits.

(ii) expenses.

(iii) incremental acquisition costs.

(e) other cash paid and, separately, other cash received.

(f) income and expense, reconciled to the amounts disclosed to comply with paragraphs 72 and 75.

(g) amounts relating to contracts acquired from, or transferred to, other insurers in portfolio transfers or business combinations.

(h) net exchange differences arising on the translation of foreign currency amounts into the presentation currency.

88 For short-duration contracts measured using the measurement described in paragraphs 54–60, an insurer shall disclose the reconciliation required by paragraph 86 separately for:

(a) pre-claims liabilities.

(b) additional liabilities for onerous insurance contracts.

(c) claims liabilities.

89 For those contracts for which uncertainty about the amount and timing of claims payments is not typically resolved fully within one year, an insurer shall disclose the claims and expenses incurred during the period.

Methods and inputs used to develop the measurements

90 To comply with paragraph 85(b), an insurer shall disclose:

(a) for the measurements that have the most material effect on the recognised amounts arising from insurance contracts, the methods used and the processes for estimating the inputs to those methods. When practicable, the insurer shall also provide quantitative information about those inputs.

(b) to the extent not covered in (a), the methods and inputs used to estimate:

(i) the risk adjustment, including information about the confidence level to which the risk adjustment corresponds. If the insurer uses a conditional tail expectation technique or a cost of capital technique, it shall disclose the confidence level to which the risk adjustment estimated under those methods corresponds (eg that the risk adjustment was estimated at conditional tail expectation (Y) and corresponds to a confidence level of Z per cent).

(ii) discount rates.

(iii) estimates of policyholder dividends.

(c) the effect of changes in the inputs used to measure insurance contracts, showing separately the effect of each change that has a material effect on the financial statements.

(d) a measurement uncertainty analysis of the inputs that have a material effect on the measurement. If changing one or more inputs used in the measurement to a different amount that could have reasonably been used in the circumstances would have resulted in a materially higher or lower measurement, the insurer shall disclose the effect of using those different amounts and how it calculated that effect. When preparing a measurement uncertainty analysis, an insurer shall not take into account inputs that are associated with remote scenarios. An insurer shall take into account the effect of correlation between inputs if such correlation is relevant when estimating the effect on the measurement of using those different amounts. For that purpose, materiality shall be judged with respect to profit or loss, and total assets or total liabilities.

Nature and extent of risks arising from insurance contracts

91 An insurer shall disclose information about the nature and extent of risks arising from insurance contracts in sufficient detail to help users of financial statements evaluate the amount, timing and uncertainty of future cash flows arising from insurance contracts.

92 To comply with paragraph 91, an insurer shall disclose:

(a) the exposures to risks and how they arise.

(b) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.

(c) any changes in (a) or (b) from the previous period.

(d) information about the effect of the regulatory frameworks in which the insurer operates, for example minimum capital requirements or required interest rate guarantees.

(e) information about insurance risk on a gross and net basis, before and after risk mitigation (eg by reinsurance) including information about:

(i) the sensitivity to insurance risk in relation to its effect on profit or loss and equity. This shall be disclosed by a sensitivity analysis that shows any material effect on profit or loss and equity that would have resulted from:

(A) changes in the relevant risk variable that were reasonably possible at the end of the reporting period;

(B) the methods and inputs used in preparing the sensitivity analysis; and

(C) any changes from the previous period in the methods and inputs used.

However, if an insurer uses an alternative method to manage sensitivity to market conditions, such as embedded value or value at risk, it can meet this requirement by disclosing that alternative sensitivity analysis.

(ii) concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (eg type of insured event, geographical area or currency). Concentrations of insurance risk can arise if an insurer has, for example:

(A) underwritten risks concentrated in one geographical area or one industry.

(B) underwritten risks that are also present in its investment portfolio, for example if an insurer provides product liability protection to pharmaceutical companies and also holds investments in those companies.

(iii) actual claims compared with previous estimates of the undiscounted amount of the claims (ie claims development). The disclosure about claims development shall go back to the period when the earliest material claim arose for which there is uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose information about the development of claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year. An insurer shall reconcile the disclosure about claims development with the carrying amount of the

insurance contract liabilities recognised in the statement of financial position.

93 For each type of risk, other than insurance risk, arising from insurance contracts, an insurer shall disclose:

(a) summary quantitative information about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to the key management personnel of the insurer and shall provide information about the risk management techniques and methodologies applied by the insurer.

(b) concentrations of risk if not apparent from other disclosures. Such concentrations can arise from, for example, interest rate guarantees that come into effect at the same level for an entire book of business.

94 With regard to credit risk arising from reinsurance contracts and, if applicable, other insurance contracts, an insurer shall disclose:

(a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period.

(b) information about the credit quality of reinsurance assets.

95 With regard to liquidity risk, an insurer shall disclose:

(a) either a maturity analysis that shows the remaining contractual maturities or information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities. This may take the form of an analysis, by estimated timing, of the amounts recognised in the statement of financial position.

(b) a description of how it manages the liquidity risk resulting from its insurance liabilities.

96 With regard to market risk (as defined in IFRS 7) an insurer shall disclose:

(a) a sensitivity analysis for each type of market risk to which the insurer is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date; if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, or a sensitivity analysis, such as value at risk, that reflects interdependencies between risk variables and uses it to manage

financial risks, it may use that sensitivity analysis to meet this requirement.

(b) an explanation of the methods and main inputs used in preparing the sensitivity analysis.

(c) an explanation of the objective of the methods used and of limitations that may result in the information not fully reflecting the carrying amount of the insurance contracts involved.

(d) changes from the previous period in the methods and inputs used and the reasons for such changes.

(e) information about exposures to market risk arising from embedded derivatives contained in a host insurance contract, including information about the levels at which these exposures begin to have a material effect on the insurer's cash flows.

97 If the quantitative information about the insurer's exposure to risk at the end of the reporting period is not representative of its exposure to risk during the period, it shall disclose that fact, the reasons for those conclusions and shall provide further information that is representative of the exposure during the period.

Effective date and transition

98 The transition requirements in paragraphs 99–102 apply both to an insurer that applies IFRSs when it first applies this [draft] IFRS and to an insurer that applies IFRSs for the first time (a first-time adopter).

99 An insurer shall apply this [draft] IFRS for annual periods beginning on or after [date to be inserted after exposure]. If an insurer applies this [draft] IFRS for an earlier period, it shall disclose that fact.

100 At the beginning of the earliest period presented, an insurer shall, with a corresponding adjustment to retained earnings:

(a) measure each portfolio of insurance contracts at the present value of the fulfilment cash flows. It follows that for insurance contracts to which these transitional provisions are applied, the measurement, both at transition and subsequently, does not include a residual margin.

(b) derecognise any existing balances of deferred acquisition costs.

(c) derecognise any intangible assets arising from insurance contracts assumed in previously recognised business combinations. That

adjustment does not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts.

Disclosure

101 In applying paragraph 92(e)(iii), an insurer need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it first applies this [draft] IFRS. Furthermore, if it is impracticable when an insurer first applies this [draft] IFRS to prepare information about claims development that occurred before the beginning of the earliest period for which the insurer presents full comparative information that complies with this [draft] IFRS, it shall disclose that fact.

Redesignation of financial assets

102 At the beginning of the earliest period presented, when an insurer first applies this [draft] IFRS, it is permitted, but not required, to redesignate a financial asset as measured at fair value through profit or loss if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition. The reclassification is a change in accounting policy and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* applies. The insurer shall recognise the cumulative effect of that redesignation as an adjustment to opening retained earnings of the earliest period presented and remove any related balances from accumulated other comprehensive income.

Appendix A
Defined terms

This appendix is an integral part of the [draft] IFRS.

acquisition costs	The direct and indirect costs of selling, underwriting and initiating an **insurance contract**.
cedant	The **policyholder** under a **reinsurance contract**.
claims handling period	The period during which the **insurer** investigates and pays claims.
claims liability	The liability to pay valid claims for **insured events** that have already occurred, including claims incurred but not reported (IBNR).
coverage period	The period during which the **insurer** provides coverage for insured events.
direct insurance contract	An **insurance contract** that is not a **reinsurance contract**.

discretionary participation feature

A contractual right to receive, as a supplement to **guaranteed benefits**, additional benefits:

(a) that are likely to be a significant portion of the total contractual benefits;

(b) whose amount or timing is contractually at the discretion of the issuer; and

(c) that are contractually based on:

(i) the performance of a specified pool of insurance contracts or a specified type of insurance contract;

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the company, fund or other entity that issues the contract,

provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity.

financial risk

The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

guaranteed benefits

Payments or other benefits to which a particular **policyholder** or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

incremental acquisition costs

The costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs.

insurance contract	A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder. (See Appendix B for guidance on this definition.)
insurance contract asset	An **insurer's** net remaining contractual rights less obligations under an **insurance contract**, if the rights exceed the obligations.
insurance contract liability	An **insurer's** net remaining contractual obligations less rights under an **insurance contract**, if the obligations exceed the rights.
insurance risk	Risk, other than **financial risk**, transferred from the holder of a contract to the issuer.
insured event	An uncertain future event that is covered by an **insurance contract** and creates **insurance risk**.
insurer	The party that has an obligation under an **insurance contract** to compensate a **policyholder** if an **insured event** occurs.
policyholder	A party that has a right to compensation under an **insurance contract** if an **insured event** occurs.
portfolio of insurance contracts	**Insurance contracts** that are subject to broadly similar risks and managed together as a single pool.
pre-claims liability	An **insurer's** stand-ready obligation to pay valid claims for future **insured events** arising under existing contracts (ie the obligation relating to the unexpired portion of risk coverage).
present value of the fulfilment cash flows	The expected present value of the future cash outflows less future cash inflows that will arise as the **insurer** fulfils the **insurance contract**, adjusted for the effects of uncertainty about the amount and timing of those future cash flows.
reinsurance assets	A **cedant's** net contractual rights under a **reinsurance contract**.
reinsurance contract	An **insurance contract** issued by one insurer (the **reinsurer**) to compensate another insurer (the **cedant**) for losses on one or more contracts issued by the cedant.

reinsurer The party that has an obligation under a **reinsurance contract** to compensate a cedant if an **insured event** occurs.

risk adjustment An adjustment to the expected present value of future cash flows, to capture the effect of uncertainty about the amount and timing of those cash flows.

unbundle Account for the components of a contract as if they were separate contracts, according to their nature.

unit-linked contract A contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund (ie a specified pool of assets held by the **insurer** or a third party and operated in a manner similar to a mutual fund). In some jurisdictions referred to as a variable contract.

Appendix B
Application guidance

This appendix is an integral part of the [draft] IFRS.

B1 This appendix provides guidance on the following issues:

(a) definition of an insurance contract (paragraphs B2–B33).

(b) measurement of an insurance contract (paragraphs B34–B110).

Definition of an insurance contract (paragraph 7 and Appendix A)

B2 This section provides guidance on the definition of an insurance contract as specified in Appendix A. It addresses the following:

(a) the term 'uncertain future event' (paragraphs B3–B5).

(b) payments in kind (paragraphs B6 and B7).

(c) insurance risk and other risks (paragraphs B8–B17).

(d) examples of insurance contracts (paragraphs B18–B22).

(e) significant insurance risk (paragraphs B23–B31).

(f) changes in the level of insurance risk (paragraphs B32 and B33).

Uncertain future event

B3 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:

(a) whether an *insured event* will occur;

(b) when it will occur; or

(c) how much the insurer will need to pay if it occurs.

B4 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

B5 Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims.

Payments in kind

B6 Some insurance contracts require or permit payments to be made in kind, in which case the insurer provides goods or services to the policyholder to settle its obligation to compensate the policyholder for insured events. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder for the amount of its loss. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the insurance contract.

B7 For some fixed-fee service contracts, the level of service depends on an uncertain event. Although such contracts meet the definition of an insurance contract if the uncertain event would cause significant additional payments by the insurer, they are outside the scope of this [draft] IFRS if the primary purpose of the contract is the provision of services. Examples of such contracts are:

(a) a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction.

(b) a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage.

Distinction between insurance risk and other risks

B8 The definition of an insurance contract refers to insurance risk, which this [draft] IFRS defines as risk, other than financial risk, transferred from the holder of a contract to the issuer. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

B9 The definition of financial risk in Appendix A includes a list of financial and non-financial variables. That list includes non-financial variables that are not specific to a party to the contract, such as an index of earthquake losses in a particular region or an index of temperatures in a particular city. It excludes non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of

changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (ie a financial variable), but also the condition of a specific non-financial asset held by a party to a contract (ie a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

B10 Some contracts expose the issuer to financial risk, in addition to significant insurance risk. For example, many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.

B11 Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided that the payment that is contingent on the insured event could be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because payment is triggered by an uncertain event—the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it shall not be separated from the host contract (see paragraph 12).

B12 The definition of insurance risk refers to risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk.

B13 The definition of an insurance contract refers to an adverse effect on the policyholder. The definition does not limit the payment by the insurer to an amount equal to the financial effect of the adverse event. For example, the definition does not exclude 'new-for-old' coverage that pays the policyholder sufficient to permit replacement of a used and damaged asset with a new asset. Similarly, the definition does not limit payment under a term life insurance contract to the financial loss suffered by the deceased's dependants, nor does it preclude the payment of predetermined amounts to quantify the loss caused by death or an accident.

B14 Some contracts require a payment if a specified uncertain event occurs, but do not require there to be an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract even if the holder uses that contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying non-financial variable that is correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. That contractual precondition does not require the insurer to investigate whether the event actually caused an adverse effect, but it does permit the insurer to deny payment if it is not satisfied that the event caused an adverse effect.

B15 Lapse or persistency risk (ie the risk that the counterparty will cancel the contract earlier or later than the issuer had expected when pricing the contract) is not insurance risk because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty. Similarly, expense risk (ie the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.

B16 Therefore, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless that contract also exposes the issuer to significant insurance risk. However, if the issuer of that contract mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.

B17 An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual entity has accepted the risk that is the essence of insurance contracts.

Examples of insurance contracts

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

(a) insurance against theft or damage to property.

(b) insurance against product liability, professional liability, civil liability or legal expenses.

(c) life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).

(d) life-contingent annuities and pensions (ie contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).

(e) insurance against disability and medical cost.

(f) surety bonds, fidelity bonds, performance bonds and bid bonds (ie contracts that compensate the holder if another party fails to perform a contractual obligation, for example an obligation to construct a building).

(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument.

(h) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this [draft] IFRS. However, product warranties issued directly by a manufacturer, dealer or retailer are within the scope of IAS 18 and IAS 37 because they either:

    (i) do not meet the definition of an insurance contract (warranties intended to provide a customer with coverage for latent defects in the product); or

    (ii) meet the definition of an insurance contract but are outside the scope of this [draft] IFRS (warranties intended to provide a customer with coverage for faults that arise after the product is transferred to the customer).

(i) title insurance (ie insurance against the discovery of defects in title to land that were not apparent when the insurance contract was issued). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(j) travel insurance (ie compensation in cash or in kind to policyholders for losses suffered during travel).

(k) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate).

(l) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract.

(m) reinsurance contracts.

B19 The following are examples of items that are not insurance contracts:

(a) investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk. For example, life insurance contracts in which the insurer bears no significant mortality risk are not insurance contracts (such contracts are non-insurance financial instruments or service contracts—see paragraphs B20 and B21).

(b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder to the issuer as a direct result of insured losses. For example, some financial reinsurance contracts or some group contracts pass all significant insurance risk back to the policyholder (such contracts are normally non-insurance financial instruments or service contracts—see paragraphs B20 and B21).

(c) self-insurance (ie retaining a risk that could have been covered by insurance). In such situations, there is no insurance contract because there is no agreement with another party.

(d) contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as death or an accident (see paragraph B13).

(e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment solely on the basis of changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (such contracts are accounted for in accordance with IFRS 9 or IAS 39).

(f) credit-related guarantees (or letters of credit, credit derivative default contracts or credit insurance contracts) that require payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (such contracts are accounted for in accordance with IFRS 9 or IAS 39).

(g) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives).

(h) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.

B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IFRS 9 or IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:

(a) one party recognises the consideration received as a financial liability, rather than as revenue; and

(b) the other party recognises the consideration paid as a financial asset, rather than as an expense.

B21 If the contracts described in paragraph B19 do not create financial assets or financial liabilities, IAS 18 applies. In accordance with IAS 18, revenue associated with a transaction involving the rendering of services is recognised as an entity satisfies its performance obligation by providing the services to the customer.

B22 The credit insurance discussed in paragraph B18(g) and the credit-related guarantees discussed in paragraph B19(f) can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. If those contracts require the issuer to make specified payments to reimburse the holder for a loss the holder incurs because a specified debtor fails to make payment when due in

accordance with the original or modified terms of a debt instrument, they are insurance contracts and are within the scope of this [draft] IFRS. However, IFRS 9 or IAS 39 apply to contracts described in paragraph B19(f), such as contracts that require payment:

(a) regardless of whether the counterparty holds the underlying debt instrument; or

(b) on a change in credit rating or change in credit index, rather than on the failure of a specified debtor to make payments when due.

Significant insurance risk

B23 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B8–B22 discuss insurance risk. The following paragraphs discuss the assessment of whether insurance risk is significant.

B24 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (ie have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely or even if the expected (ie probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining cash flows from the insurance contract.

B25 In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.

B26 In determining whether it will pay significant additional benefits in a particular scenario, the insurer takes into account the effect of the time value of money. As a result, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. Consider the following reinsurance example. A cedant enters into a contract covering a book of one-year contracts. The contract provides that the reinsurer's payment will be ten years after the start of the contract. At the beginning of the contract, the reinsurer expects that claims will range from CU1,000 to CU1,200.* In assessing whether the reinsurance

* In this [draft] IFRS, monetary amounts are denominated in 'currency units (CU)'.

contract transfers significant insurance risk, the reinsurer considers the present value of the future payments in each scenario, ie not their nominal amounts. Assuming a discount rate of 5 per cent, the relevant benefit payments range from CU614 to CU737 (ie the nominal payments discounted at a rate of 5 per cent over 10 years).

B27 The additional benefits described in paragraph B24 refer to the present value of amounts that exceed the present value of amounts that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:

(a) the loss of the ability to charge the policyholder for future services. For example, in an investment-linked life insurance contract, the death of the policyholder means that the insurer can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the insurer does not reflect insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of a client. Therefore, the potential loss of future investment management fees is not relevant in assessing how much insurance risk is transferred by a contract.

(b) waiver on death of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, the waiver of these charges does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in assessing how much insurance risk is transferred by a contract.

(c) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay CU1 million if an asset suffers physical damage causing an insignificant economic loss of CU1 to the holder. In this contract, the holder transfers to the insurer the insignificant risk of losing CU1. At the same time, the contract creates non-insurance risk that the issuer will need to pay CU999,999 if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract.

(d) possible reinsurance recoveries. The insurer accounts for these separately.

B28 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements (for that purpose, contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract). Thus, insurance risk can be significant even if there is a minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.

B29 It follows from paragraphs B24–B28 that if a contract pays a death benefit exceeding the amount payable on survival, the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire book of contracts). As noted in paragraph B27(b), the waiver on death of cancellation or surrender charges is not included in this assessment if that waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

B30 Paragraph B24 refers to additional benefits. Those additional benefits could include a requirement to pay benefits earlier if the insured event occurs earlier and the payment is not adjusted for the time value of money. An example is whole life insurance for a fixed amount (ie insurance that provides a fixed death benefit whenever the policyholder dies, with no expiry date for the cover). It is certain that the policyholder will die, but the date of death is uncertain. The insurer will suffer a loss on those individual contracts for which policyholders die early, even if there is no overall loss on the whole book of contracts.

B31 If an insurance contract is unbundled in accordance with paragraph 8 into an insurance component and one or more other components (eg an investment component), the significance of insurance risk transfer is assessed by reference to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

Changes in the level of insurance risk

B32 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the annuity rates charged by the insurer to other new annuitants at the time the policyholder exercises the option. Such a contract transfers no insurance risk to the issuer until the option is exercised because the insurer remains free to price the annuity on a basis that reflects the insurance risk transferred to the insurer at that time. However, if the contract specifies the annuity rates (or a basis for setting the annuity rates), the contract transfers insurance risk to the issuer at inception.

B33 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished (ie discharged, or cancelled or expires).

Measurement of insurance contracts

B34 This section provides guidance on the measurement of insurance contracts. It addresses the following:

(a) initial measurement (paragraph B35).

(b) initial measurement of reinsurance contracts (paragraph B36).

(c) estimates of future cash flows (paragraphs B37–B66).

(d) risk adjustments (paragraphs B67–B103).

(e) insurance contracts acquired in portfolio transfers (paragraphs B104–B107).

(f) insurance contracts acquired in a business combination (paragraphs B108 and B109).

(g) measurement of insurance contracts on transition (paragraph B110).

Initial measurement (paragraphs 17–46)

B35 Paragraph 17 requires an insurer to measure an insurance contract initially at the present value of the fulfilment cash flows plus a residual margin that eliminates any gain at inception of the contract. A residual margin arises if the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows. However, if the present value of the fulfilment cash flows is greater than zero (ie the expected present value of the future cash outflows plus the risk adjustment exceeds the expected present value of the future cash inflows), paragraph 18 requires that an expense shall be recognised immediately. Furthermore, paragraph 39(a) requires an insurer to include in the present value of fulfilment cash flows those acquisition costs that are incremental at the level of an individual contract. The following example illustrates how an insurer applies these principles.

Example 1 – Initial measurement of insurance contracts

An insurer issues an insurance contract, receives CU50 as the first premium payment and incurs acquisition costs of CU70, of which incremental acquisition costs are CU40. The insurer estimates an expected present value (EPV) of subsequent premiums of CU950 and a risk adjustment of CU50. In example 1A, the insurer estimates that the EPV of future claims is CU900. In Example 1B, the insurer estimates that the EPV of claims is CU920. The present value of the fulfilment cash flows is the difference between the EPV of cash inflows (CU1,000) and the EPV of fulfilment cash outflows (CU940 in Example 1A and CU960 in Example 1B), less the risk adjustment (CU50). At initial recognition, the insurer would measure the insurance contract as follows:

	Example 1A	Example 1B
	CU	CU
EPV of cash outflows	940	960
Risk adjustment	50	50
EPV of cash inflows	(1,000)	(1,000)
Present value of the fulfilment cash flows	(10)	10
Residual margin	10	0
Liability at initial recognition	**0**	**10**

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The effect on profit or loss will be the following:		
Loss at initial recognition	0	10
Non-incremental acquisition costs (CU70–CU40)	30	30
Loss	30	40

Immediately after initial recognition, the carrying amount of the insurance contract liability changes as follows because of the cash flows (first premium and incremental acquisition costs) arising on the day of initial recognition (see paragraph 24):

EPV of cash outflows	900	920
Risk adjustment	50	50
Residual margin	10	0
EPV of cash inflows	(950)	(950)
Liability immediately after initial recognition	**10**	**20**

Initial measurement of reinsurance contracts (paragraphs 43–46)

B36 Paragraph 43 requires a cedant to measure a reinsurance contract initially at the present value of the fulfilment cash flows plus a residual margin. A residual margin arises for a reinsurance contract if the expected present value of the future cash inflows (eg recoveries) plus the risk adjustment is less than the expected present value of future cash outflows (eg premium ceded to the reinsurer). However, if the present value of the fulfilment cash flows is greater than zero (ie the expected present value of the future cash inflows plus the risk adjustment exceeds the expected present value of the future cash outflows), paragraph 45(b) of this [draft] IFRS requires that a gain shall be recognised. The following example illustrates how a cedant applies these principles.

Example 2 – Initial measurement of reinsurance contracts

A cedant enters into a 30 per cent proportional reinsurance contract. At initial recognition of the reinsurance contract, the cedant measures the corresponding underlying insurance contract, which it issued at the same moment, as follows:

	CU
Single premium	(1,000)
Expected present value (EPV) of claims	870
Incremental acquisition costs	30
Risk adjustment	60
Present value of fulfilment cash flows	**(40)**
Residual margin	**40**
Liability at initial recognition	**0**

From the characteristics of the underlying insurance contract, the cedant estimates the following:

- expected present value (EPV) of cash inflows of CU261 (recovery of 30 per cent of the EPV of claims payable to the policyholder of CU870 for the underlying insurance liability);
- risk adjustment of CU18 (30 per cent of the risk adjustment of CU60 for the underlying insurance liability); and
- EPV of cash outflows (the single reinsurance premium paid to the reinsurer, less ceding commissions received from the reinsurer) of
  - in example 2A, CU285;
  - in example 2B, CU275.

Assuming that the risk of non-performance by the reinsurer is negligible, the measurement of the asset arising from the reinsurance contract would be:

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	Example 2A	Example 2B
	CU	CU
EPV of cash inflows (recoveries)	261	261
Risk adjustment	18	18
EPV of cash outflows (premium ceded)	(285)	(275)
Present value of the fulfilment cash flows	(6)	4
Residual margin	6	0
Asset at initial recognition	**0**	**4**
The effect on profit or loss will be the following:		
Gain at initial recognition	**0**	**4**

Estimates of future cash flows (paragraphs 23–25)

B37 This section addresses:

(a) uncertainty and the expected present value approach (paragraphs B38–B41).

(b) market variables and non-market variables (paragraphs B42–B52).

(c) source of estimates (paragraph B53).

(d) using current estimates (paragraphs B54–B56).

(e) future events (paragraphs B57–B60).

(f) which cash flows (paragraphs B61–B64).

(g) level of measurement (paragraphs B65 and B66).

Uncertainty and the expected present value approach

B38 The starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome in order to derive an expected present value. Thus, the aim is

not to develop a single 'best' estimate of future cash flows, but, in principle, to identify all possible scenarios and make unbiased estimates of the probability of each scenario. In some cases, an insurer has access to considerable data and may be able to develop those cash flow scenarios easily. But in other cases, the insurer may not be able to develop more than general statements about the variability of cash flows without incurring considerable cost. In those cases, the insurer shall use those general statements in estimating the future cash flows.

B39 When considering all possible scenarios, the objective is not necessarily to identify every possible scenario but rather to incorporate all relevant information and not simply ignore data or information that is difficult to obtain. In practice, it is not always necessary to develop explicit scenarios. For example, if an insurer estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will suffice to estimate those parameters. Similarly, in some cases, relatively simple modelling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions (eg if the cash flows reflect a series of interrelated implicit or explicit options). In such cases, more sophisticated stochastic modelling is likely to be needed, including the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes.

B40 The probability assigned to each scenario shall reflect conditions at the end of the reporting period. For example, there may be a 20 per cent probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period and before the financial statements are authorised for issue, a storm strikes. The present value of the fulfilment cash flows under that contract shall not reflect the storm that, with hindsight, is known to have occurred. Instead, the cash flows included in the measurement are multiplied by the 20 per cent probability that was apparent at the end of the reporting period (with appropriate disclosure that a non-adjusting event occurred after the end of the reporting period in accordance with IAS 10 *Events after the Reporting Period*).

B41 The scenarios developed shall include unbiased estimates of the probability of catastrophic losses under existing contracts. However, the scenarios exclude possible claims under possible future contracts. For example, suppose there is a 5 per cent probability that an earthquake during the remaining coverage period of an existing contract will cause losses with a present value of CU1,000,000. In that case, the expected present value of the cash outflows includes CU50,000 (ie CU1,000,000 × 5 per cent) for those catastrophe losses. But the expected value of the cash outflows for that contract does not include the possible catastrophe losses from an earthquake that could happen after the end of the coverage period.

Market variables and non-market variables

B42 The cash flows shall reflect the manner in which the insurer expects to fulfil the contract. A search for market inputs is not required, except for market variables such as interest rates. Therefore, this application guidance distinguishes between two types of variables:

(a) market variables—variables that can be observed in, or derived directly from, markets (eg prices of publicly traded securities and interest rates).

(b) non-market variables—all other variables (eg the frequency and severity of insurance claims and mortality).

Market variables

B43 Estimates of market variables shall be consistent with observable market prices at the end of the reporting period. An insurer shall not substitute its own estimates for observed market prices.

B44 Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Therefore, they are not a single point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was 'wrong'.

B45 An important application of market variables is the notion of a replicating asset, or a replicating portfolio of assets. A replicating asset is one whose cash flows exactly match those contractual cash flows in amount, timing and uncertainty. In some cases, a replicating asset may exist for some of the cash flows arising from an insurance contract. The fair value of that asset reflects the expected present value of the cash flows from the asset, and it also reflects the risk associated with those

cash flows. If a replicating portfolio of assets exists for some or all of the cash flows arising from an insurance contract liability, the insurer can for those contractual cash flows simply include the fair value of those assets in the present value of the fulfilment cash flows, instead of explicitly estimating the expected present value of those particular cash flows and the associated risk adjustment. For cash flows not measured by a replicating portfolio of assets, an insurer estimates explicitly the expected present value of those particular cash flows and the associated risk adjustment.

B46 This [draft] IFRS does not require an insurer to use a replicating portfolio technique. However, if a replicating asset exists and an insurer uses a different technique, the insurer shall satisfy itself that a replicating portfolio technique would be unlikely to lead to a materially different answer. One way to assess whether that is the case is to verify that applying the other technique to the cash flows generated by the replicating portfolio produces a measurement that is not materially different from the fair value of the replicating portfolio.

B47 As an example of a replicating portfolio technique, suppose an insurance contract contains a feature that generates cash flows equal to the cash flows from a put option on a basket of traded assets. The replicating portfolio for those cash flows would be a put option with the same features. The insurer would observe or estimate the fair value of that option and include that amount in the measurement of the entire insurance contract. However, the insurer could use a technique other than a replicating portfolio if that technique, in principle, is expected to achieve the same measurement of the contract as a whole. For example, other techniques may be more robust or easier to implement if there are significant interdependencies between the embedded option and other features of the contract. Judgement is required to determine which approach best meets the objective in practice in particular circumstances.

Non-market variables

B48 Estimates of non-market variables shall reflect all available evidence, both external and internal.

B49 Non-market external data (eg national mortality statistics) may have more or less relevance than internal data (eg internal mortality statistics), depending on the circumstances. For example, a life insurer shall not rely solely on national mortality statistics, but shall consider all other

available internal and external sources of information in developing unbiased estimates of probabilities for mortality scenarios. In developing those probabilities, an insurer shall consider all evidence available, giving more weight to evidence that is more persuasive. For example:

(a) internal mortality statistics may be more persuasive than national mortality data if the internal statistics are derived from a large population, the demographic characteristics of the insured population differ significantly from those of the national population and the national statistics are out of date; in that case, an insurer would place more weight on the internal data and less weight on the national statistics.

(b) conversely, if the internal statistics are derived from a small population with characteristics believed to be close to those of the national population, and the national statistics are current, an insurer would place more weight on the national statistics.

B50 Estimated probabilities for non-market variables shall not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios shall be as consistent as possible with probabilities implied by market interest rates. Paragraphs B51 and B52 discuss this further.

B51 In some cases, an insurer concludes that market variables vary independently of non-market variables. If so, the insurer shall prepare scenarios that reflect the range of outcomes for the non-market variables and each scenario shall use the same observed value of the market variable.

B52 In other cases, market variables and non-market variables may be correlated. For example, there may sometimes be evidence that lapse rates are correlated with interest rates. Similarly, there may sometimes be evidence that claim levels for house or car insurance are correlated with economic cycles and hence with interest rates and expense amounts. In such cases, an insurer shall develop scenarios for different outcomes of the variables. The insurer shall calibrate the probabilities for the scenarios, and risk adjustments relating to the market variables, so that they are consistent with observed market prices that depend on those market variables.

Source of estimates

B53 An insurer estimates the probabilities associated with future payments under existing contracts on the basis of:

(a) information about claims already reported by policyholders.

(b) other information about the known or estimated characteristics of the portfolio of insurance contracts.

(c) historical data about the insurer's own experience, supplemented when necessary with historical data from other sources. Historical data are adjusted if, for example:

(i) the characteristics of the portfolio differ (or will differ, because of adverse selection) from that of the population used as a basis for the historical data.

(ii) there is evidence that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows arising from the existing insurance contracts.

(iii) there have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the portfolio of insurance contracts.

(d) current price information, if available, for reinsurance contracts and other instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of portfolios of insurance contracts. This information is adjusted for differences between the cash flows arising from those reinsurance contracts or other instruments, and the cash flows that would arise as the insurer fulfils the underlying contracts with the policyholder.

Using current estimates

B54 In estimating the probability of each cash flow scenario relating to non-market variables, an insurer shall use all available current information at the end of the reporting period. An insurer shall review the estimates of probabilities it made at the end of the previous reporting period and update them if evidence indicates that the previous estimates are no longer valid. In doing so, an insurer shall consider both:

(a) whether the updated estimates represent faithfully conditions at the end of the reporting period, and

(b) whether changes in estimates represent faithfully changes in conditions during the period. For example, suppose that estimates were at one end of a reasonable range at the beginning of the

period. If conditions have not changed, changing the estimates to the other end of the range at the end of the period would not faithfully represent what has happened during the period. If an insurer's most recent estimates are, initially, different from its previous estimates, but conditions have not changed, the insurer shall assess whether the new probabilities assigned to each scenario can be justified. In updating its estimates of those probabilities, the insurer shall consider both the evidence that supported its previous estimates and all available new evidence, giving more weight to evidence that is more persuasive.

B55 Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience last year was 20 per cent worse than previous experience and previous expectations. Several factors could have caused the sudden change in experience, including:

(a) lasting changes in mortality.

(b) changes in the characteristics of the insured population (eg changes in underwriting or distribution, or selective lapses by policyholders in unusually good or bad health).

(c) flaws in the estimation model, or mis-calibration of parameters, such as mortality and lapse rates, used in the model.

(d) random fluctuations.

(e) identifiable non-recurring causes.

B56 An insurer shall investigate the reasons for the change in experience and develop new probability estimates for the possible outcomes, in the light of the most recent experience, earlier experience and other information. Typically, the result for this example would be that the expected present value of death benefits increases, but not by as much as 20 per cent. Actuaries have developed various 'credibility' techniques that an insurer could use in assessing how new evidence affects the probability of different outcomes. In this example, if mortality continues to be significantly higher than previous estimates, the estimated probability assigned to high-mortality scenarios will increase as new evidence becomes available.

Future events

B57 Estimates of non-market variables shall consider not just current information about the current level of insured events, but also information about trends. For example, mortality rates have declined consistently over long periods in many countries. In developing cash flow scenarios, an insurer shall assign probabilities to each possible trend scenario in the light of all available evidence.

B58 Similarly, if cash flows from the insurance contract are sensitive to inflation, cash flow scenarios shall reflect possible future inflation rates (see also paragraph B52). Because inflation rates are likely to be correlated with interest rates, an insurer shall calibrate the probabilities for each inflation scenario so that they are consistent with probabilities implied by market interest rates (eg those used in estimating the discount rate specified in paragraphs 30–34).

B59 In estimating the cash flows from an insurance contract, an insurer shall take into account future events that might affect the cash flows without changing the nature of the obligation. The insurer shall develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability weights for each scenario.

B60 However, an insurer shall not take into account future events, such as a change in legislation, that would change or discharge the present obligation or create new obligations under the existing insurance contract.

Which cash flows?

B61 Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract that are incremental at the level of a portfolio of insurance contracts, and no others. Cash outflows that are incremental to a portfolio of insurance contracts include direct costs and systematic allocations of costs that relate directly to the insurance contracts or contract activities. Accordingly, the relevant cash flows include:

(a) premiums (including premium adjustments and instalment premiums) from policyholders and any additional cash flows that result from those premiums.

(b) payments to (or on behalf of) policyholders, including claims that have already been reported but have not yet been paid (ie reported claims), claims that have already been incurred but have not yet

been reported (IBNR) and all future claims and other benefits under the existing contract.

(c) claim handling costs (ie the costs that the insurer will incur in processing and resolving claims under existing insurance contracts, including legal and adjuster's fees and internal costs of processing claim payments).

(d) the costs that the insurer will incur in providing contractual benefits that are paid in kind.

(e) cash flows that will result from options and guarantees embedded in the contract, to the extent those options and guarantees are not unbundled (see paragraph 12). When insurance contracts contain embedded options or guarantees, it is particularly important to consider the full range of scenarios.

(f) the incremental costs of selling, underwriting and initiating an insurance contract for those contracts that have been issued and that the insurer has incurred because it has issued that particular contract (ie the incremental acquisition costs). Thus, these costs are identified at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts.

(g) policy administration and maintenance costs, such as costs of premium billing and costs of handling policy changes (eg conversions and reinstatements). Such costs also include recurring commissions expected to be paid to intermediaries if a particular policyholder continues to pay the premiums specified in the insurance contract.

(h) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or can be attributed to them on a reasonable and consistent basis.

(i) potential recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent they do not qualify for recognition as separate assets, potential recoveries on past claims.

(j) payments to current or future policyholders as a result of a contractual participation feature (including those features implied in the contract by regulatory or legal requirements) that provides

policyholders with participation in the performance of a portfolio of insurance contracts or pool of assets.

B62 The following cash flows shall not be considered in estimating the cash flows that will arise as the insurer fulfils an existing insurance contract:

(a) investment returns. The investments are recognised, measured and presented separately. However, the measurement of a participating insurance liability is affected by the cash flows, if any, that depend on the investment returns.

(b) payments to and from reinsurers. Reinsurance assets are recognised, measured and presented separately.

(c) cash flows that may arise from future insurance contracts, ie cash flows that are outside the boundary of existing contracts (see paragraphs 26 and 27), or from options, forwards and guarantees that do not relate to the existing insurance contract. Nevertheless, estimates of cash flows from existing contracts are not performed on a run-off basis. In other words, those estimates do not incorporate changes in the cash flows from existing contracts that could take place if the insurer stopped issuing new contracts, unless the insurer actually stops issuing new contracts.

(d) acquisition costs other than incremental acquisition costs.

(e) cash flows arising from abnormal amounts of wasted labour or abnormal amounts of other resources used to fulfil the contract.

(f) costs that do not relate directly to the contract or contract activities, such as general overheads.

(g) income tax payments and receipts. Such payments and receipts are recognised, measured and presented separately in accordance with IAS 12 *Income Taxes*.

(h) cash flows between different components of the reporting entity, such as between policyholder funds and shareholder funds.

(i) cash flows arising from components that are unbundled from the insurance contract (eg interest that the insurer expects to credit to policyholder account balances). See paragraphs 8 and 9.

B63 Some costs relate directly to insurance contracts or contract activities but are the result of activities that cover more than one portfolio (eg salaries of staff of a claims handling department working on more than one portfolio). An insurer shall allocate those costs, other than acquisition costs (see paragraph B61(f)), on a rational and consistent basis to

individual portfolios of insurance contracts. Even though such costs are allocations, they are still incremental at the portfolio level. Costs that are not incremental at the portfolio (or lower) level because they do not relate directly to the insurance contract or contract activities, such as general overheads, are not allocated to portfolios and therefore are not included in the measurement of insurance contracts.

B64 In some cases an insurer incurs costs that in substance are the equivalent of cash outflows. For example, an insurer may own a workshop to repair cars for damages covered under an insurance contract. The cash flows include the depreciation of that workshop because it is a resource required to satisfy the insurer's obligation from its insurance contract.

Level of measurement

B65 In principle, the expected (probability-weighted) cash flows from a portfolio of insurance contracts equal the sum of the expected cash flows of the individual contracts. Therefore, the level of aggregation for measurement does not affect the expected present values of future cash flows.

B66 However, from a practical point of view, it may be easier to perform some types of estimate in aggregate for a portfolio, rather than for individual insurance contracts. For example, IBNR estimates are typically made in aggregate. Similarly, if expenses are incremental at the portfolio level but not at an individual insurance contract level, it may be easier, and perhaps even necessary, to estimate them at an aggregate level. However, in principle, this is no different from making expected value estimates for individual insurance contracts and then aggregating the results for the portfolio of those contracts.

Risk adjustments (paragraphs 35–37)

B67 This section addresses:

(a) objective and characteristics (paragraphs B68–B72).

(b) techniques for estimating risk adjustments (paragraphs B73 and B74).

(c) features of permitted risk adjustment techniques (paragraphs B75–B90).

(d) application of risk adjustment techniques (paragraphs B91–B102).

(e) risk adjustments and the use of a replicating portfolio (paragraph B103).

Objective and characteristics

B68 The risk adjustment conveys information to users of financial statements about the effects of uncertainty about the amount and timing of the cash flows arising from an insurance contract. To achieve this, paragraph 35 requires that the risk adjustment shall be the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.

B69 Because the purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows arising from the insurance contract only, the risk adjustment shall reflect all risks associated with that contract. It shall not reflect risks that do not arise from the insurance contract, such as investment risk (except when investment risk affects the amount of payments to policyholders), asset-liability mismatch risk or general operational risk relating to future transactions.

B70 The risk adjustment shall be included in the measurement in an explicit way. Thus, the risk adjustment is separate from estimates of future cash flows and the discount rate that adjusts those cash flows for the time value of money; it cannot be included implicitly in those two other building blocks. However, that requirement is not intended to preclude 'replicating portfolio' approaches (see paragraph B103).

B71 Care is needed to avoid duplicating adjustments for risk (see also paragraphs B45 and B103).

B72 To meet the objective in paragraph B68, the risk adjustment shall, to the extent practicable, have the following characteristics:

(a) risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity.

(b) for similar risks, contracts with a longer duration will result in higher risk adjustments than those of a shorter duration.

(c) risks with a wide probability distribution will result in higher risk adjustments than those risks with a narrower distribution.

(d) the less that is known about the current estimate and its trend, the higher the risk adjustment shall be.

(e) to the extent that emerging experience reduces uncertainty, risk adjustments will decrease and vice versa.

Techniques for estimating risk adjustments

B73 An insurer shall use only the following techniques for estimating risk adjustments:

(a) confidence level (paragraphs B75–B79).

(b) conditional tail expectation (paragraphs B80–B83).

(c) cost of capital (paragraphs B84–B90).

B74 Paragraphs B75–B90 provide an overview of the main features of those permitted techniques. Paragraphs B91–B102 discuss how the permitted techniques could meet the characteristics in paragraph B72 and indicate when they are applicable.

Features of permitted risk adjustment techniques

Confidence level

B75 The confidence level technique expresses the likelihood that the actual outcome will be within a specified interval. The confidence level technique is sometimes referred to as Value at Risk (VaR). The International Actuarial Association's paper *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins* describes the use of confidence levels in estimating a risk adjustment as follows:

> [Risk adjustment techniques] based on confidence levels express uncertainty in terms of the extra amount that must be added to the expected value so that the probability that the actual outcome will be less than the amount of the liability (including the risk [adjustment]) over the selected time period equals the target level of confidence.

B76 The use of confidence levels for estimating a risk adjustment has the benefits of being relatively easy to communicate to users and relatively easy to calculate. However, the usefulness of confidence level diminishes when the probability distribution is not statistically normal (which is often the case for insurance contracts). When the probability distribution is not normal (in which case, the probability distribution may be skewed and the mean may not equal the median), the selection of the confidence level must take into account additional factors, such as the skewness of the probability distribution. In addition, this technique ignores outliers (ie extreme losses in the tail of the distribution beyond the specified confidence level).

B77 For example, suppose a confidence level of 95 per cent is used and the following estimates are made for two insurance contracts:

(a) for contract A, the 95 per cent confidence level is at CU1,000 and the remaining 5 per cent of the distribution is evenly spread from CU1,001 to CU1,010.

(b) for contract B, the 95 per cent confidence level is at CU1,000 and the remaining 5 per cent of the distribution is evenly spread from CU1,001 to CU2,000.

B78 At the 95 per cent confidence level, those two contracts would have the same risk adjustment. However, at, for example, the 97 per cent confidence level, contract A would be measured at CU1,004 and contract B at CU1,400.

B79 Judgement is required to determine the confidence level (ie what percentage) to set for particular portfolios of insurance contracts in particular circumstances. In setting the confidence level, an insurer needs to consider factors, such as the shape of the distribution, which may differ by portfolio. Because the distribution can change over time, the insurer may need to change the confidence level accordingly in future periods.

Conditional tail expectation

B80 A conditional tail expectation (CTE) (also referred to as a tail conditional expectation or a tail value at risk) technique is an enhancement of VaR. A CTE technique provides a better reflection of the potentially extreme losses than VaR by incorporating the expected value of those extreme losses into the measurement of the risk adjustment (although a confidence level technique may meet the objective of the risk adjustment if the distribution is not particularly skewed). The Society of Actuaries' paper *Analysis of Methods for Determining Margins for Uncertainty under a Principle-Based Framework for Life Insurance and Annuity Products* describes a CTE technique as follows:

> The CTE technique is a modified percentile approach that combines the percentile and mean values of different cases. It basically calculates the mean of losses within a certain band (or tail) of pre-defined percentiles. With the CTE method, the margin is calculated as the probability weighted average of all scenarios in the chosen tail of the distribution less the mean estimate (which may or may not be the median, i.e. the 50^{th} percentile).

B81 The CTE over, for example, the 75 per cent confidence level (referred to as CTE(75)) is the expected value of all outcomes that are in the highest 25 per cent of the claim distribution (ie in the tail). The risk adjustment in this case would be the expected value of claims at CTE(75) less the expected value (ie mean) of claims for the entire probability distribution.

B82 The focus of a CTE technique on the tail of the probability distribution reflects a fundamental aspect of an insurance contract—the fact that the tail is the riskiest part of the distribution. Tail risk is an important factor in contracts with skewed payments, such as insurance contracts that contain embedded options (eg the interest guarantees and other financial guarantees embedded in many life insurance products) or that cover low-frequency high-severity risks (such as an earthquake), or portfolios that contain significant concentrations of risk. For example, if a large portfolio of insurance contracts is subject to significant earthquake risk but the insurer estimates that the probability of an earthquake occurring is only 1 per cent, the measurement of the insurance contract should not ignore that risk. As part of the estimation of the amount an insurer would rationally pay to be relieved of the risk, significant consideration needs to be given to the tail of the loss distribution. Consequently, CTE techniques would meet the objective for a risk adjustment described in paragraph B68. However, a confidence interval technique may meet the objective if distributions are not particularly skewed.

B83 Judgement is required to determine the CTE band set for particular portfolios of insurance contracts in particular circumstances. In setting the CTE band, an insurer will consider the shape of the distribution. Because the distribution can change over time, the CTE band may need to change accordingly in future periods.

Cost of capital

B84 Cost of capital techniques are applied for a number of purposes, for example pricing insurance contracts, valuations in business combinations, regulatory reporting, internal capital management and supplementary reporting. For general purpose financial reporting, a cost of capital technique can be used to estimate a risk adjustment that reflects the uncertainty about the amount and timing of the future cash flows that will arise as an insurer fulfils its existing insurance contracts.

B85 In order to fulfil an insurance contract, an insurer needs to hold and maintain a sufficient amount of capital. If an insurer does not have sufficient capital, it might be unable to fulfil its obligations and the policyholders would be likely to surrender their insurance contracts.

B86 An insurer applies a cost of capital technique as follows:

(a) first, the insurer derives an estimated probability distribution for the cash flows.

(b) secondly, the insurer sets a confidence level from that distribution. That confidence level is intended to provide a high degree of certainty that the insurer will be able to fulfil its obligations under existing insurance contracts. The difference between the amount at that confidence level and the expected value (ie mean) of claims for the entire probability distribution indicates a capital amount that corresponds to the high degree of certainty that the insurer will be able to fulfil its obligations under the portfolio of existing insurance contracts, ignoring any risk factors not related to those contracts.

(c) lastly, the insurer estimates the risk adjustment by:

(i) applying a factor, in the form of an appropriate annual rate, to that capital over the lifetime of the contract, and

(ii) making a further adjustment for the time value of money because the capital will be held in future periods.

B87 For example, suppose an insurer sets the capital amount as the amount necessary to provide for a confidence level of 99.5 per cent, and estimates that the corresponding capital amount is CU100. Suppose also that the insurer estimates that the appropriate capital rate is 8 per cent per year, and that it will need to hold the capital amount for one year. Therefore, the risk adjustment will be CU8 (ie the capital amount of CU100 at 8 per cent for one year). For simplicity, this example assumes that the time value of money is not material. However, the computation of the risk adjustment using the capital amount and the annual rate needs to reflect the time value of money, which is particularly relevant if a capital amount is held for a longer period.

B88 To meet the objective for a risk adjustment (ie to estimate the amount an insurer would rationally pay to be relieved of the risk that the actual fulfilment cash flows will exceed those expected), both the amount of capital and the capital rate need to be derived in an appropriate way, as follows:

(a) the amount of capital shall be set at a sufficiently high level that it captures almost the entire tail of the distribution. To do this, an insurer will need to identify how much uncertainty exists in the tail of the distribution.

(b) the capital rate shall reflect the risks that are relevant to the liability (ie those risks that the owners of the insurer would require for exposure to the risk in the liability), but not reflect risks that are not relevant to the liability (eg asset risk for non-participating

insurance contracts and avoidable mismatch risk) or those risks that are already captured elsewhere in the model. For example, suppose investors require an 18 per cent return for investing in an insurer, including:

(i) 4 per cent relating to the time value of money (ie the risk-free rate, which is not related to the insurance liability; the insurer can generate that return by investing the capital amount in risk-free assets and so does not need to generate that return from the insurance liabilities);

(ii) 2 per cent relating to asset risks borne by the insurer;

(iii) 1 per cent relating to avoidable asset/liability mismatch risk taken by the insurer; and

(iv) 3 per cent relating to uncertainty about future business (including operational risk related to future business).

This results in a capital rate of 8 per cent relating to the capital return (ie the residual, which is calculated as 18 per cent − 4 per cent − 2 per cent − 1 per cent − 3 per cent).

B89 The cost of capital technique reflects almost the entire distribution, and only a relatively small band on the far end of the distribution, beyond the selected confidence level for the capital amount, would not be considered. This is because the confidence level for determining the capital amount is set at a level that is intended to provide a high degree of certainty that the insurer will be able to fulfil its obligations under existing insurance contracts. Therefore, in setting the confidence level in the cost of capital technique, an insurer takes into account the possibility of low-frequency high-severity losses in all but the extreme tail of the probability distribution. Because the cost of capital technique takes into account the release of the capital amount over the life of the contract, this technique also reflects how the risk associated with the insurance contract changes over time.

B90 The confidence level for the capital amount, and the annual rate applied to that capital amount to calculate the risk adjustment, shall be set in a way that reflects the characteristics of the liability at each point in time. Conceptually, it would be possible to apply different confidence levels and different capital rates to different types of contracts. However, it may be possible to apply a consistent confidence level and capital rate to different portfolios (and over time) because the capital amount needs to be set so that it captures almost the entire distribution.

Application of risk adjustment techniques

B91 Paragraph B72 sets out the characteristics that a risk adjustment must have in order to satisfy the objective (ie to estimate the amount an insurer would rationally pay to be relieved of the risk that the actual fulfilment cash flows may exceed those expected). All three techniques permitted by this [draft] IFRS meet those characteristics in at least some, but not necessarily all, situations and will do so in varying degrees depending on the circumstances.

B92 The selection of the most appropriate risk adjustment technique depends on the nature of an insurance contract. An insurer shall apply judgement in determining the most appropriate technique to use for each type of insurance contract. In applying that judgement, an insurer shall also consider the following:

(a) the technique must be implementable at a reasonable cost and in a reasonable time, and be auditable;

(b) the technique must provide concise and informative disclosure so that users of financial statements can benchmark the insurer's performance against the performance of other insurers. Paragraph 90(b)(i) requires disclosure of the confidence levels used for the three permitted techniques.

B93 The following paragraphs describe when each technique is more likely to be appropriate.

Shape of the probability distribution

B94 Paragraph B72(a) states that risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity. In other words, risk adjustments will be larger for probability distributions that are more skewed.

B95 Because a confidence level technique focuses on one point in the probability distribution, it satisfies this characteristic only if the distribution is not particularly skewed. Consequently, a confidence level technique is not appropriate for distributions that are highly skewed.

B96 A CTE technique can satisfy this characteristic, even for skewed distributions, because it considers all outcomes above the confidence level.

B97 Similarly, cost of capital techniques can satisfy this characteristic, even for skewed distributions, if the required capital is set at a sufficiently high level to capture almost the entire tail of the distribution.

Contract duration

B98 Paragraph B72(b) states that, for similar risks, contracts with a longer duration will result in higher risk adjustments than those of shorter duration. The confidence level and CTE techniques achieve this to the extent that the insurer's estimate of the distribution of outcomes takes account of this factor. Cost of capital techniques achieve this in a way that explicitly reflects the changing shape of the distribution over time by applying a capital factor (rate) to the capital required during each period during the life of the contract.

Width of probability distribution

B99 Paragraph B72(c) states that risks with a wide probability distribution will result in a higher risk adjustment than risks with a narrower distribution. A confidence level technique achieves this if the additional width of the distribution is below the selected confidence level. A CTE technique achieves this because it takes into account the entire tail. A cost of capital technique takes into account the width of the distribution when the widening of the distribution does not occur further out in the tail of the distribution than the confidence level used to estimate the required capital.

Uncertainty of estimates

B100 Paragraph B72(d) states that the less that is known about the current estimate and its trend, the higher the risk adjustment shall be. A confidence level technique and a CTE technique could take into account this characteristic by, for example, setting a higher confidence level. A cost of capital technique could take it into account by, for example, increasing the confidence level used to estimate the required capital.

Emerging experience

B101 Paragraph B72(e) states that to the extent that emerging experience reduces uncertainty, risk adjustments will decrease (and vice versa). All three of the techniques meet this characteristic because emerging experience will affect the loss distribution and, therefore, the amount of the risk adjustment.

B102 Thus, in summary, when the probability distribution is not skewed and does not vary significantly over time, a confidence level technique can typically provide a risk adjustment that possesses the characteristics described in paragraph B72. However, when the probability distribution is skewed or varies significantly over time, a CTE technique or cost of capital technique is more appropriate, because those approaches result in a risk adjustment that is likely to be more sensitive to the shape of the distribution of possible outcomes around the mean (and, thus, the risk) and to changes in its shape over time.

Risk adjustments and the use of a replicating portfolio

B103 The requirement that a risk adjustment is included in the measurement in an explicit way (ie separately from the expected cash flows and discount rate building blocks), does not preclude a 'replicating portfolio' approach as described in paragraphs B45–B47. To avoid double-counting, the risk adjustment does not include any risk that is captured in the fair value of the replicating portfolio.

Insurance contracts acquired in portfolio transfers (paragraph 40)

B104 Paragraph 40 requires an entity to measure a portfolio of insurance contracts acquired in a portfolio transfer at the higher of the consideration received and the present value of the fulfilment cash flows.

B105 If the consideration received is higher than the present value of the fulfilment cash flows, the excess (ie the consideration received less the present value of the fulfilment cash flows) establishes the residual margin at initial recognition (which will be recognised in profit or loss over the coverage period in accordance with paragraph 50.

B106 If the present value of fulfilment cash flows is higher than the consideration received, the excess (ie the present value of the fulfilment cash flows less the consideration received) is immediately recognised in profit or loss as an expense in accordance with paragraph 18.

B107 The following example illustrates how an entity applies this principle.

Example 3 – Measurement of a portfolio of insurance contracts acquired in a portfolio transfer

An insurer acquires a portfolio of insurance contracts in a portfolio transfer. The consideration received is CU30. In Example 3A, the insurer estimates that the present value of the fulfilment cash flows is CU20, which is lower than the consideration received. In Example 3B, the insurer estimates that the present value of the fulfilment cash flows is CU45, which is higher than the consideration received. At initial recognition, the insurer measures the insurance contract liability as follows:

	Example 3A	Example 3B
	CU	CU
Present value of the fulfilment cash flows	20	45
Residual margin	10	0
Liability at initial recognition	**30**	**45**

In Example 3A, the insurer measures the portfolio at the consideration received of CU30. As a result, the difference of CU10 between the consideration received and the present value of the fulfilment cash flows establishes the residual margin at initial recognition.

In Example 3B, the insurer measures the portfolio at the expected present value of CU45. As a result, the difference of CU15 between the consideration received and the present value of the fulfilment cash flows is recognised as an expense at initial recognition.

Insurance contracts acquired in a business combination (paragraph 42)

B108 Paragraph 42 requires an insurer to measure a portfolio of insurance contracts acquired in a business combination at the higher of the fair value of the portfolio and the present value of the fulfilment cash flows. If the present value of the fulfilment cash flows is higher than the fair value, the excess (ie the present value of the fulfilment cash flows less the fair value) would increase the initial carrying amount of goodwill recognised in the business combination.

B109 The following example illustrates how an entity applies this principle.

Example 4 – Measurement of a portfolio of insurance contracts acquired in a business combination

An insurer acquires a portfolio of insurance contracts in a business combination. The fair value of the portfolio is CU30. In Example 4A, the insurer estimates that the present value of fulfilment cash flows is CU20, which is lower than the fair value. In Example 4B, the insurer estimates that the present value of the fulfilment cash flows amounts to CU45, which is higher than the fair value. At initial recognition, the insurer measures the insurance contract liability as follows:

	Example 4A	Example 4B
	CU	CU
Present value of the fulfilment cash flows	20	45
Residual margin	10	0
Liability at initial recognition	**30**	**45**

In Example 4A, the insurer measures the portfolio at its fair value of CU30. As a result, the difference of CU10 between the fair value and the present value of the fulfilment cash flows establishes the residual margin at initial recognition.

In Example 4B, the insurer measures the portfolio at the present value of the fulfilment cash flows of CU45. As a result, goodwill initially recognised in the business combination is CU15 higher than it would have been if the insurer had measured the portfolio at its fair value of CU30.

Measurement of insurance contracts on transition (paragraph 100)

B110 The transition requirements in paragraph 100 require an insurer to measure an insurance contract at the present value of the fulfilment cash flows, and to recognise any resulting adjustment in retained earnings. In addition, an insurer shall derecognise any existing balances of deferred acquisition costs and any intangible assets relating to existing insurance contracts assumed in previous business combinations with a corresponding adjustment to retained earnings. The following example illustrates how an entity applies this principle.

Example 5 – Measurement of insurance contracts on transition

An entity presented the following amounts in its financial statements in accordance with its previous accounting policies:

	CU
Deferred acquisition costs (DAC)	150
Intangible assets relating to existing contracts	125
Intangible assets relating to possible future contracts	75
Insurance contract liabilities	(900)

On the date of transition, the entity estimates that the present value of the fulfilment cash flows of its insurance liabilities is CU630. The entity also concludes that the intangible assets relating to possible future contracts are appropriately recognised and measured in accordance with IFRSs.

As a result, the entity recognises the following adjustments on the date of initial recognition:

- a decrease in insurance liabilities of CU270 (CU900 − CU630);
- a total decrease in assets of CU275 to derecognise the DAC of CU150 and the intangible assets relating to existing insurance contracts of CU125; and
- a net reduction of CU5 in retained earnings (CU275 − CU270).

Appendix C
Amendments to other IFRSs

The Board expects to make the amendments described below when it finalises the new standard on insurance contracts.

Standard	Description of amendment
• IFRS 1 *First-time Adoption of International Financial Reporting Standards*	• Delete second sentence of D4. This refers to material in IFRS 4 that is no longer relevant. • Delete reference in IG58A to financial guarantee contracts. See draft amendment to IAS 39.
• IFRS 3 *Business Combinations*	• Introduce a measurement exception for insurance contracts, consistent with paragraph 42 of the exposure draft.
• IFRS 7 *Financial Instruments: Disclosures* and IAS 32 *Financial Instruments: Presentation*	• Delete the definition of financial guarantee contracts. • Amend the scope exclusion for insurance contracts, to treat financial guarantee contracts in the same way as all other insurance contracts. At present, some requirements of IFRS 7 and IAS 32 apply to such contracts, but the proposed requirements for insurance contracts would remove the need for this. • Introduce a scope exclusion for investment contracts with a discretionary participation feature. As a result, paragraph 29(c) of IFRS 7, which exempts entities from disclosing the fair value of these contracts, would become redundant. • Amend example in paragraph AG8 of IAS 32 (a financial guarantee contract) so that the example provided is a financial instrument, not an insurance contract. An example could be a guarantee that requires a payment in response to changes in specified credit ratings (IAS 39, paragraph AG4(b)).

• IFRS 9 *Financial Instruments* and IAS 32 *Financial Instruments: Presentation*	• Introduce a requirement to recognise and measure at fair value through profit or loss shares issued by an insurer and held as part of a pool of assets underlying unit-linked contracts.
• IAS 16 *Property, Plant and Equipment*	• Introduce a requirement to measure at fair value through profit or loss property owned and occupied by the insurer that is part of a pool of assets underlying unit-linked contracts.
• IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*	• Delete the scope exclusion for deferred acquisition costs arising from insurance contracts, as such items will no longer exist.
• IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	• Delete Example 9, which illustrates existing requirements for financial guarantee contracts, and replace it with an example illustrating the IAS 37 requirements for other guarantee obligations (such as statutory guarantees) that would continue to be within the scope of IAS 37.
• IAS 39 *Financial Instruments: Recognition and Measurement*	• Delete the definition of a financial guarantee contract ('a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument'). • Amend the scope exclusion for insurance contracts, to treat financial guarantee contracts in the same way as all other insurance contracts. Delete paragraph 47(c) on subsequent measurement of financial guarantee contracts. Update discussion of financial guarantee contracts in paragraph AG4 to reflect these changes. • Update paragraph AG4E(b) to reflect the use of current information in the proposed measurement model for insurance contracts.

Approval by the Board of *Insurance Contracts* published in July 2010

The exposure draft *Insurance Contracts* was approved for publication by eleven of the fourteen members of the International Accounting Standards Board. Messrs Engström and Smith voted against its publication. Their alternative views are set out after the Basis for Conclusions. Mr Pacter abstained from voting in view of his recent appointment to the Board.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Elke König	
Patricia McConnell	
Warren J McGregor	
Paul Pacter	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

July 2010

Basis for Conclusions
Exposure Draft ED/2010/8

Insurance Contracts

Comments to be received by 30 November 2010

Basis for Conclusions on Exposure Draft

INSURANCE CONTRACTS

Comments to be received by 30 November 2010

ED/2010/8

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Insurance Contracts* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **30 November 2010.** Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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ALTERNATIVE VIEWS

Basis for Conclusions on the exposure draft *Insurance Contracts*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 The International Accounting Standards Board developed the exposure draft *Insurance Contracts* after analysing responses to the proposals in its discussion paper *Preliminary Views on Insurance Contracts* (published in May 2007). The exposure draft is part of phase II of the Board's project on accounting for insurance contracts.

BC2 This Basis for Conclusions summarises the Board's considerations in reaching the conclusions in the exposure draft. Individual Board members gave greater weight to some factors than to others.

Background

The Board's project on insurance contracts

BC3 The Board's predecessor organisation, the International Accounting Standards Committee, began a project on insurance contracts in 1997. The Board was constituted in 2001 and included that project in its initial work plan. Because it was not feasible to complete the project in time for the many insurers that would adopt International Financial Reporting Standards (IFRSs) in 2005, the Board split the project into two phases.

BC4 The Board completed phase I in 2004 by issuing IFRS 4 *Insurance Contracts*, which:

(a) made limited improvements to accounting practices for insurance contracts.

(b) permitted a wide variety of accounting practices for insurance contracts to continue, thus avoiding major changes that phase II might reverse.

(c) required an insurer to disclose information about insurance contracts.

BC5 The Board aims to complete phase II of the insurance contracts project by issuing an IFRS based on the proposals in the exposure draft. The objective of phase II is to develop a high quality standard addressing the recognition, measurement, presentation and disclosure requirements for insurance contracts. The Board believes that IFRS 4 cannot remain in place indefinitely because it permits diversity in practice, including many practices that do not provide users of financial statements with information that is relevant and representationally faithful. In particular, existing practice has the following flaws:

(a) Some practices have developed in a piecemeal fashion over many years and do not provide a coherent framework for dealing with more complex contracts (such as multi-line or stop-loss contracts) or resolving emerging issues with new types of insurance contract.

(b) Accounting methods have sometimes been tailored more to meeting the needs of insurance regulators than to meeting the sometimes different needs of investors and other capital providers.

(c) Some practices used by insurers differ from those used by other entities, particularly other financial institutions, such as banks and fund managers, but there is not a sound reason for all those differences. These differences impede comparisons between insurers and other financial institutions. They can also mean that financial conglomerates produce financial statements that are internally inconsistent.

BC6 In May 2007 the Board published a discussion paper setting out its preliminary views on the main components of an accounting model for an insurer's rights and obligations (ie assets and liabilities) arising from an insurance contract. The Board received 162 comment letters in response. Most respondents said that a new IFRS for insurance contracts was needed urgently and agreed with the Board that the measurement of an insurance contract should take into account three building blocks: estimates of future cash flows, the effect of the time value of money and a risk adjustment. However, virtually all respondents had significant concerns about particular aspects of those building blocks. Feedback on the discussion paper's proposals is discussed in paragraphs BC45–BC50.

BC7 After publishing the discussion paper, the Board continued to consult the Insurance Working Group, a group of senior financial executives of insurers, analysts, actuaries, auditors and regulators that was established in 2004. In addition, in 2009 the Board conducted field tests to

understand better some aspects of the practical application of the proposed insurance model. Sixteen insurers, based in Asian, Australian, European and North American markets and with life, non-life and reinsurance businesses, participated.

FASB views on insurance contracts

BC8 In August 2007 the US Financial Accounting Standards Board (FASB) issued to its constituents an Invitation to Comment *An FASB Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*, which included the IASB discussion paper. The FASB received 44 comment letters in response. In October 2008 the FASB decided to participate in the project jointly with the IASB. However, this project is not part of the Memorandum of Understanding agreed with the FASB, which has the aim of achieving improvements in accounting standards and increasing the convergence of IFRSs and US generally accepted accounting principles (GAAP).

BC9 After the FASB joined the project, most of the Board's discussions on the insurance contracts model were held jointly with the FASB and many of the decisions on the features of the model were made jointly with the FASB. However, the Board is publishing its exposure draft on insurance contracts separately from the FASB. The FASB plans to publish a discussion paper to seek additional input from constituents. That discussion paper would present the IASB's proposals, the FASB's tentative decisions, and a comparison of each of those models with existing US generally accepted accounting principles (GAAP).

BC10 This Basis for Conclusions identifies the few areas in which the IASB and the FASB reached different views on particular aspects of the insurance accounting model. Differences between the IASB's decisions and those of the FASB are summarised in the Appendix.

The proposals in the exposure draft

BC11 The exposure draft proposes a comprehensive measurement approach for all types of insurance contracts, although a modified version of that approach would apply for some short-duration contracts. That comprehensive measurement approach:

(a) would measure an insurance contract using a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects the contract to generate as it fulfils the contract (paragraphs BC14–BC155).

(b) would provide information about the main drivers of insurance contract profitability in the current period (paragraphs BC156–BC187).

BC12 This Basis for Conclusions first discusses the Board's proposals on how an insurer measures and presents insurance contracts in its financial statements. It then discusses how those conclusions helped shape the other proposals in the exposure draft:

(a) scope (paragraphs BC189–BC225). The draft IFRS would apply to insurance contracts as defined in the draft IFRS (ie life and non-life, direct insurance and reinsurance), in both the pre-claims period (the coverage period when the insurer is standing ready to meet valid claims) and the claims handling period (when the insured events have occurred but the ultimate payment is uncertain). The draft IFRS would also apply when an issuer of a financial instrument with a discretionary participation feature accounts for such an instrument.

(b) recognition and derecognition (paragraphs BC226–BC229). The draft IFRS proposes that an insurer should recognise an insurance contract when it becomes party to the contract and derecognise it when the liability has been extinguished.

(c) reinsurance (paragraphs BC230–BC241). The draft IFRS proposes that the same model applies to reinsurance and to direct insurance.

(d) disclosures (paragraphs BC242–BC253).

(e) transition, effective date and early adoption (paragraphs BC254–BC257).

BC13 Finally, this Basis for Conclusions describes the Board's assessment of the benefits and costs of implementing the draft IFRS (paragraphs BC258–BC263).

Measurement (paragraphs 16–66)

The need to revise the measurement model

BC14 Insurance contracts create a bundle of rights and obligations that generate a package of cash inflows and cash outflows, including:

(a) premiums received from the customer.

(b) benefits paid to policyholders to satisfy valid claims.

(c) costs of investigating whether claims are valid and of settling those claims (claims handling costs).

(d) costs of servicing contracts during their life.

(e) additional payments to holders of participating insurance contracts (eg dividends and bonuses).

(f) interest credits to holders of account-driven contracts, such as the contracts known in some countries as universal life contracts.

(g) payments resulting from the options, guarantees and other derivatives embedded in many insurance contracts.

BC15 The simplest insurance contracts, for example many non-life insurance contracts, provide only insurance coverage. However, many other insurance contracts blend together several types of cash flows arising from various components that would, if issued as free-standing contracts, be subject to a variety of accounting treatments. Those components include:

(a) pure insurance, as noted above.

(b) pure deposits, for example financial instruments whereby an entity receives a fixed sum and undertakes to repay that sum with fixed interest on a fixed date.

(c) financial derivatives, for example interest rate options or options linked to an equity index.

(d) non-insurance services, such as pension administration, asset management or custody services, for example of mutual fund assets.

BC16 Examples of contracts that contain such components are:

(a) life insurance contracts with significant deposit elements.

(b) unit-linked contracts (known in some countries as variable contracts) with guarantees of minimum returns in specified circumstances, such as on death, maturity, surrender or annuitisation.

(c) participating contracts that provide insurance coverage and an investment return, supplemented by guarantees of a minimum investment return in specified circumstances.

(d) life insurance contracts with surrender options, conversion options, options to cease or suspend payment, or options to reduce or extend coverage.

BC17 The Board considered the following approaches to developing an accounting model for insurance contracts:

(a) applying generally applicable IFRSs to insurance contracts (paragraphs BC18–BC35).

(b) selecting an existing model for accounting for insurance contracts, such as existing US GAAP (paragraphs BC36–BC38).

(c) developing a new accounting model appropriate to insurance contracts (paragraphs BC39–BC44).

Applying generally applicable IFRSs

BC18 Insurance contracts are excluded from the scope of many current or proposed generic standards that might otherwise apply to such contracts, including standards on:

(a) Revenue recognition (see exposure draft *Revenue from Contracts with Customers*, published in June 2010).

(b) Liabilities (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, see also the related exposure draft *Measurement of Liabilities in IAS 37*, published in January 2010).

(c) Financial instruments (see IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 9 *Financial Instruments*, IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosure*. See also the related exposure drafts proposing amendments to those IFRSs, such as the exposure draft *Fair Value Option for Financial Liabilities*, published in May 2010).

BC19 Broadly speaking, bringing insurance contracts within the scope of those standards would have the following consequences:

(a) An insurer would identify service elements and deposit elements within each premium.

(b) For the service element, the insurer would account for the premium as proposed in the exposure draft *Revenue from Contracts with Customers* (see paragraphs BC20–BC32). The insurer would account for the claims liability in accordance with IAS 37 (see paragraph BC33).

(c) The insurer would apply the financial instruments standards to the deposit element.

Revenue recognition

BC20 If an insurer applied the proposals in the exposure draft *Revenue from Contracts with Customers* ('the proposed revenue recognition model'), to the service elements of the premium, the insurer would:

(a) identify the separate performance obligations in the contract, and allocate the revenue element across those performance obligations to determine the transaction price for each performance obligation.

(b) measure those performance obligations that remain unsatisfied at the amount of transaction price that is allocated to those performance obligations.

(c) recognise an additional liability if a performance obligation is onerous.

(d) recognise revenue as the insurer satisfies a performance obligation by providing insurance coverage. Typically, revenue would be recognised continuously over the coverage period.

(e) recognise a claims liability when a claim is incurred.

BC21 It would not be difficult to apply the revenue recognition model to some types of insurance contract, eg many short-duration contracts, and that model would provide useful information for users. Indeed, the result of applying the revenue recognition model to those contracts would be largely similar to the approach proposed in the draft IFRS on insurance contracts. Paragraphs BC145–BC148 explain this in more detail.

BC22 However, for other types of insurance contract, it would be much more difficult to apply the revenue recognition model and the results would be of limited use to users. Examples of some of the problem areas are:

(a) stop-loss contracts and some contracts with significant deductibles.

(b) contracts for which the expected cost of an insured event is likely to fluctuate both up and down over time (eg for some types of guarantee).

(c) contracts that implicitly provide protection against a decline in insurability.

(d) annuities.

(e) investment management services in participating insurance contracts.

BC23 The following example illustrates the problem with applying the proposed revenue recognition model to stop-loss contracts and to contracts with deductibles. Suppose a stop-loss contract covers 90 per cent of aggregate losses during 2010 that exceed CU10 million,* up to a maximum payment of CU9 million (ie 90 per cent of aggregate losses in the layer between CU10 million and CU20 million). The premium is, say, CU1.2 million. Consider now the position at 30 June 2010. Suppose that aggregate losses for the first six months are CU5 million, and aggregate losses for the rest of the year might be less than CU5 million (probability 60 per cent), between CU5 million and CU15 million (total probability 35 per cent, with all amounts within that range equally likely) or CU15 million or more (probability 5 per cent). To apply the revenue recognition model to this contract, it would be necessary to answer the following questions:

(a) To what extent has the insurer satisfied its performance obligation at 30 June 2010? How much revenue should the insurer recognise at that date as a result?

(b) How much, if any, should the insurer recognise as a claims liability at 30 June 2010? At that date it does not yet know whether it will be required to pay any claims at all for the year, but it could have to pay as much as CU9 million for the year as a whole, and the expected value of its payments for the whole year is CU2,025,000.†

BC24 Applying the model proposed in the draft IFRS, the insurer does not need to identify an amount of revenue attributable to the coverage for the six months to 30 June 2010, or to identify an amount of 'incurred' losses at that date. It simply measures the contract as the sum of the expected present value of the remaining cash flows (the present value of CU2,025,000) plus a risk adjustment plus the remaining amount of the residual margin identified at inception.

BC25 The revenue recognition model is also not particularly well suited to contracts for which the risk is likely to fluctuate both up and down over time (eg for some types of guarantee). Suppose an equity-linked life insurance contract provides a death benefit equal to the higher of (a) the account value and (b) 100 per cent of the amount invested. Thus, the insurer bears the risk that the policyholder may die at a time when the

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* In this Basis for Conclusions monetary amounts are denominated in 'currency units (CU)'.

† There is a 35% probability that the insurer will pay CU4,500,000 and a 5% probability that it will pay 9,000,000. Thus, the expected value of losses for the whole year = (35% × 4,500,000) + (5% × 9,000,000) = CU2,025,000.

account value is less than the amount invested. For bearing this risk, the insurer charges an explicit or implicit additional premium of CU1,000. Halfway through the life of the contract, what part of the insurer's performance obligation has it satisfied if the account value stands at (a) 130 per cent of the amount invested? (b) 100 per cent of the amount invested? (c) 70 per cent of the amount invested? What if the account value goes down to 70 per cent of the amount invested and then goes back up to 100 per cent? The revenue recognition model does not provide ready answers to these questions.

BC26 Many life insurance contracts pose another difficulty for the revenue recognition model. Consider a 20-year life insurance contract with monthly fixed level premiums, with the insurer having no ability to reprice the contract during its term. The premium paid for each month provides the policyholder with two benefits:

(a) coverage against death during that month.

(b) coverage against the possibility of a decline in insurability, or even against becoming uninsurable, in the event of bad health.

BC27 In principle, the revenue recognition model would require the insurer to estimate at inception the stand-alone selling price for each month of coverage, or find some reasonable approximation that would allocate the total premium in a reasonable way across each month of coverage. Moreover, for the coverage for, say, the 70th month of cover, the revenue recognition model would require the insurer, at least in principle, to estimate the stand-alone selling price at inception for that month's coverage. Estimating that price is likely to be difficult because insurers do not generally sell such forward coverage separately. The pricing of such forward cover would need to consider how the characteristics of a portfolio might change between inception and the 70th month for example, because of adverse selection (ie the fact that the policyholders with different characteristics are likely to exercise lapse or other options in different ways, leading to an increasing concentration of policyholders who present above-average levels of risk).

BC28 A life-contingent annuity can be viewed as a series of pure endowments. A pure endowment is a contract that pays a specified benefit if the policyholder is alive on a specified date. Each of those pure endowments obliges the insurer to stand ready to pay out the specified benefit if the policyholder survives to the specified date. Thus, for annuities, the revenue recognition model would, in principle, require the insurer to allocate the total transaction price across each pure endowment contained in the contract. Assuming the annuity requires monthly

payments, the insurer would recognise each month as revenue the portion of the transaction price allocated to the obligation maturing in that month. Furthermore, for policyholders who die during the month, the insurer no longer has any performance obligations to them and so would recognise the remaining transaction price as revenue during that month. And if the policyholders are expected to live longer than previously expected, the insurer would need to reallocate transaction price across performance obligations accordingly. The resulting model is not likely to provide useful information to users and it is likely to be complex to implement.

BC29 For some participating insurance contracts, the insurer provides investment management services and provides a guarantee of minimum investment returns, receiving in exchange a portion of the upside potential on the underlying assets. The revenue recognition model would require the insurer to identify and estimate the amount of consideration receivable from the policyholder (in the form of a portion of the upside potential) and allocate it across satisfied and unsatisfied performance obligations.

BC30 A further problem arises because the revenue recognition model applies different approaches to contract rights and unsatisfied performance obligations, by measuring:

(a) the contract rights on an expected present value basis.

(b) the unsatisfied performance obligations at the amount of consideration allocated to those obligations, supplemented by an onerous contract test based on future cash flows.

BC31 Applying different approaches to contract rights and performance obligations amounts to an implicit assumption that the contract generates two separate streams of cash flows that are independent of each other. However, that is not the case for many insurance contracts. As an example, consider a 20-year life insurance contract with monthly premiums. If the contract lapses because the policyholder does not pay the premium for month 60, the insurer will not pay death benefits if the policyholder dies in month 61 or after. Similarly, if the policyholder dies in month 35, the insurer will not receive premiums for month 36 or after. Accounting for the inflows separately from the outflows would not represent their nature faithfully because it would imply that the inflows and outflows do not affect each other. In contrast, the approach proposed in the draft IFRS treats all inflows and outflows in the same manner.

BC32 In summary, applying the revenue recognition model would be relatively easy for some insurance contracts (eg many short-duration contracts) and would provide relevant information for users, but would be complex and produce information of limited relevance for other types of insurance contracts. In contrast, the model proposed in the draft IFRS would provide useful information for all types of insurance contract.

Applying IAS 37 to the claims liability

BC33 If an insurer were to apply IAS 37 to the claims liability, it would recognise a claims liability as insured events occur, and would measure that claims liability both initially and subsequently in accordance with IAS 37. That measurement would involve current estimates of cash flows and a current market-based discount rate reflecting the risks specific to the liability. In January 2010, the exposure draft *Measurement of Liabilities in IAS 37* elaborated on those requirements by proposing that the measurement should be the amount the entity would rationally pay to be relieved of the obligation. That exposure draft also included more explicit proposals on the inclusion of a risk adjustment and on the inclusion of a margin broadly corresponding to the service margin proposed in the discussion paper on insurance contracts.

Treating deposit elements as financial liabilities

BC34 If an insurer accounted for the deposit elements of an insurance contract in the same way as other financial liabilities, the insurer would:

(a) measure the deposit elements at fair value through profit or loss or at amortised cost (as applicable).

(b) measure the deposit elements so that the fair value of the deposit element would be no less than the amount payable on demand, discounted from the first date that the payment could be required (the 'deposit floor', discussed in paragraphs BC65 and BC66).

(c) account separately for embedded options and guarantees when so required by financial instruments standards (see paragraphs BC76–BC82).

(d) recognise acquisition costs as an expense when incurred, with no corresponding gain at inception. Under IAS 39, if the deposit element is measured at amortised cost, incremental transaction costs relating to the deposit element would reduce the initial carrying amount of that liability.

BC35 Other reasons why the Board rejected the idea of simply bringing insurance contracts within the scope of generic standards are the difficulty, and possible arbitrariness, of identifying which deposits and which embedded derivatives should be accounted for separately and the complexity and lack of usefulness of applying different approaches to different components of complex contracts.

Selecting an existing model

BC36 Some respondents to the discussion paper (mainly from the US) suggested that the Board should develop an approach based on existing US GAAP for insurers. The Board rejected this approach because existing US GAAP for insurers is based on numerous standards developed at different times.

BC37 The Board also decided that it would not be appropriate to account for insurance contracts using other existing accounting models because many such models:

(a) do not use current estimates of all cash flows.

(b) do not include an explicit risk margin.

(c) fail to reflect the time value or intrinsic value of some or all embedded options and guarantees, or they determine time value or intrinsic value in a way that is inconsistent with current market prices.

(d) capture both the intrinsic value and the time value of some, but not necessarily all, embedded options or guarantees by treating them as free-standing derivatives (an approach often described as 'bifurcation' or 'unbundling'). Paragraph BC41 describes why the Board does not think that such bifurcation approaches result in a faithful representation of the rights and obligations in an insurance contract.

(e) present an insurer's financial performance, particularly for life insurance, in a manner that is difficult for users to understand.

BC38 Accordingly, the Board concluded that it should develop an accounting model specifically for insurance contracts.

A new accounting model for insurance contracts

BC39 The draft IFRS proposes a new accounting model that reflects the Board's view that insurance contracts blend financial elements with service elements in various proportions, depending on the type of contract, and

that those elements combine to generate a package of cash inflows and cash outflows. The model comprises the following elements:

(a) a direct measurement that incorporates the underlying cash flows at their expected present value and includes a risk adjustment. The draft IFRS uses the term 'present value of fulfilment cash flows' to refer to that measurement.

(b) a residual margin that reports profitability of the contract over the coverage period. The residual margin is part of the consideration received or receivable from the policyholder and is determined at inception. The accounting for the residual margin is largely consistent with the proposed treatment of customer consideration in the exposure draft *Revenue from Contracts with Customers*.

BC40 The Board rejected an approach in which the accounting for an insurance contract attempts to identify a predominant component, because this would probably create significant discontinuities between the accounting for similar contracts that lie on different sides of an arbitrary dividing line.

BC41 The Board also rejected an approach that accounts separately for each component in the contract (a bifurcation approach). In the Board's view, bifurcation approaches do not faithfully represent the package of rights and obligations in an insurance contract for the following reasons:

(a) There is inherent arbitrariness in determining when a component should be bifurcated. This may result in separation of one component but not of another component that generates similar exposures. For example, a cedant may be required to bifurcate an embedded option or guarantee from a reinsurance asset, but not the same exposure in the underlying direct insurance contracts issued by the cedant.

(b) Bifurcation ignores interdependencies between components with the result that the sum of the values of the components does not equal the value of the entire contract, even at inception. Moreover, after inception, components may be measured on different measurement bases, causing even greater divergence between the sum of the carrying amounts of the components and the value of the contract as a whole. Furthermore, applying different accounting requirements to components can be complex and may not generate relevant or understandable information for users.

(c) If significant interdependencies are present, the embedded option or guarantee is itself likely to meet the definition of an insurance contract. In that case, the embedded option or guarantee is

unlikely to be bifurcated, even if similar risks arise from other embedded derivatives that do require bifurcation.

BC42 Although the Board has rejected a bifurcation approach, the proposed accounting model would require components of an insurance contract to be separated (ie unbundled) if the cash flows attributable to the individual component can be identified separately. The draft IFRS specifies particular components of an insurance contract that should be unbundled. This is discussed in paragraphs BC210–BC219.

BC43 In the Board's view, the main benefit of proposing a single method for all types of insurance contracts, including reinsurance contracts (with some modification for some short-duration contracts, as discussed in paragraphs BC145–BC148), rather than a patchwork of different approaches for different contract types and contract features, is that this would provide users with information prepared consistently for these various types. It would also limit the need for arbitrary rules on matters such as embedded derivatives and financial reinsurance. The model also provides a coherent framework to deal with more complex contracts (such as multi-year, multi-line or stop-loss contracts and contracts that contain embedded options and guarantees). This would enable emerging issues to be resolved within that framework rather than by developing specific responses to those issues that could result in the creation of unprincipled distinctions or arbitrary new rules. It would also reduce the need for the Board to respond to developments in practice by issuing frequent amendments to the IFRS.

BC44 Furthermore, the Board believes that the particular model proposed in the draft IFRS would produce relevant information for users of an insurer's financial statements because it provides:

(a) more relevant information about the amount, timing and uncertainty of future cash flows that will arise as the insurer fulfils its existing insurance contracts.

(b) explicit and robust estimates of cash flows, using a consistent approach for all changes in estimates that is also consistent with the approach to estimating future cash flows for other financial and non-financial liabilities in IFRSs.

(c) information about risk, through the inclusion of an explicit risk adjustment. This would be relevant information for users because accepting and managing risk is the essence of insurance.

(d) consistent treatment of both the time value and intrinsic value of all options and guarantees embedded in insurance contracts.

(e) clear reporting of economic mismatches that occur when insurance liabilities and related assets respond differently to the same changes in economic conditions.

(f) a reduction in accounting mismatches that arises if changes in economic conditions affect assets and liabilities equally, but the accounting requirements do not adjust the carrying amounts of those assets and liabilities equally in response to those economic changes.

(g) consistency with observable current market prices for financial market variables, such as interest rates and equity prices, to the extent that they are available.

(h) a presentation approach that highlights the main drivers of an insurer's profitability during the period.

(i) a clear and understandable approach for acquisition costs, by treating incremental acquisition costs as cash flows arising from the related insurance contract. Non-incremental acquisition costs would be recognised as an expense when incurred. (See paragraphs BC135–BC140.)

Development of the measurement approach

BC45 The draft IFRS proposes that an insurer should measure an insurance contract in a way that portrays a current assessment of the insurance contract, based on the present value of the fulfilment cash flows and a residual margin that reports profitability of the contract over the coverage period. This measurement approach is based on the building blocks approach proposed in the discussion paper. As discussed below, the Board has modified its previous proposals in the light of responses to the discussion paper and input provided by the Insurance Working Group and others.

BC46 The discussion paper proposed that insurers should measure their insurance contracts at current exit value, representing the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The discussion paper proposed that an insurer should determine that amount using the following three building blocks:

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.

(b) current market discount rates that adjust the estimated future cash flows for the time value of money.

(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).

BC47 Respondents to the discussion paper generally agreed that the three building blocks of cash flows, time value of money and a risk margin provided a useful framework for thinking about the measurement of insurance contracts and largely supported the following features of the building block approach:

(a) using current estimates of cash flows, rather than carrying forward estimates made at contract inception (ie locked-in estimates).

(b) using interest rates and, if applicable, equity prices that are based on observable market data.

(c) using the expected value (ie probability-weighted average) of future cash flows rather than a single, most likely outcome. Some respondents expressed concerns about using expected value. Although these concerns were sometimes expressed in terms of disagreement with the principle, the root of many of the concerns seemed to be about how this principle would be applied in practice.

(d) reflecting the time value of money (although, as noted in paragraphs BC88–BC104, some disagreed with this for non-life insurance).

(e) including a risk margin, and recognising income as the insurer is released from risk (although, as noted in paragraphs BC105–BC120, some disagreed with this for non-life insurance).

(f) recognising a gain at inception to reflect the expected recovery of acquisition costs from the overall contract margins.

BC48 Because respondents generally agreed with the proposals specified in paragraph BC47, this Basis for Conclusions does not discuss them again unless otherwise noted above.

BC49 Although respondents to the discussion paper generally found the three building blocks a helpful tool for analysis, virtually all respondents had concerns about significant aspects of the particular building blocks proposed in the discussion paper and its proposed objective of a current exit value. Those concerns can be summarised as follows:

(a) *Fulfilment cash flows*: Many respondents suggested that the objective of the measurement approach should reflect the fact that insurers generally expect to fulfil their liabilities over time by paying benefits and claims to policyholders as they become due, rather than reflecting an estimate of the price for a transfer of the liabilities to a third party. They stated that a transfer objective is the wrong principle for items that will not be, and often cannot be, transferred, even if current exit value might often be very close to a fulfilment value in practice. In addition, those respondents objected to current exit value because:

(i) it requires the insurer to use estimates of the cash flows that would arise for market participants, rather than cash flows that would arise for the insurer itself. Although these two sets of cash flows would probably be similar in most respects, except possibly for servicing costs in some cases, respondents generally believed that reference to market participants would be confusing and would produce less relevant information.

(ii) it reflects the risk that the debtor (in this case, the insurer) will not fulfil its obligation to perform under the contract (non-performance risk or own credit risk). Most respondents opposed the inclusion of non-performance risk.

(iii) it could lead to gains at the inception of an insurance contract. The discussion paper expressed the Board's view that such gains would arise rarely in practice, and explained that the Board was divided on whether to calibrate current exit value at inception in such a way that no gain would be recognised at inception. Respondents were similarly divided on whether an insurer should recognise gains at inception, beyond any gains relating to recovery of acquisition costs.

Paragraphs BC51–BC87 describe the Board's discussion of fulfilment cash flows.

(b) *Policyholder behaviour and participation*: Many respondents expressed concerns about the discussion paper's approach to future premiums and other aspects of policyholder behaviour and to payments to participating policyholders. They expressed the view that measurement should focus on the contract as a whole, and should not try to assess whether each element of a contract meets the definition of an asset or a liability (paragraphs BC67–BC75).

(c) *Time value of money*: There were mixed views among respondents about how to discount the cash flows arising from insurance contracts. In particular:

(i) There were mixed views about whether discounting and risk margins are appropriate for non-life insurance contracts. Paragraphs BC89–BC94 describe the Board's reasons for requiring discounting for all insurance contracts. Similar considerations apply to risk adjustments.

(ii) Most respondents agreed with the Board that the discount rate for non-participating liabilities should reflect the characteristics of the liabilities, not those of the assets backing those liabilities. However, other respondents supported using asset-based rates, to be consistent with common pricing practice and to avoid recognising large losses at inception for contracts that, on an expected value basis, are likely to be profitable. Paragraphs BC95–BC97 discuss this issue further.

(iii) Some respondents questioned whether the discount rate used to discount cash flows arising from insurance contract should be a risk-free rate or whether there should be an adjustment for liquidity. Paragraphs BC98–BC104 discuss this issue further.

(d) *Risk margins*: Many respondents requested more information on how to estimate risk margins and were concerned about the lack of observable benchmarks for risk margins. Some advocated narrowing the range of acceptable methods for estimating risk margins, although many said that guidance on estimating risk margins should be based on principles.

(e) *Service margin*: Most respondents opposed the inclusion of a service margin.

BC50 In the light of comments made by respondents to the discussion paper and subsequent discussions, the Board amended the proposed measurement model as follows:

(a) The model focuses on the fact that insurers generally fulfil their contracts directly over time by paying benefits and claims to policyholders, rather than by transferring the contracts to a third party. In addition, the model does not reflect the risk of non-performance by the insurer, and prohibits the recognition of a gain at inception (paragraph BC51).

(b) The model treats the contract as a single liability or asset, without assessing individual components for separate recognition. This is particularly relevant when considering how to measure the effects of policyholder behaviour and future premiums and policyholder participation (paragraphs BC67–BC75).

(c) The Board proposes to narrow the range of permitted methods for determining the risk adjustment (margin) and to provide additional guidance on its determination (paragraphs BC105–BC120).

(d) The model does not include an explicit service margin. If any such margin is implicit in the pricing of contracts, it would be reflected in the residual margin.

Fulfilment cash flows (paragraph 22(a))

BC51 The draft IFRS proposes that insurers should measure insurance liabilities using cash flows that will arise through fulfilment because this reflects how the insurer expects to extinguish the liability—by fulfilling the liability through payment of benefits and claims to policyholders as they become due. The present value of the fulfilment cash flows is built up from an estimate of future cash flows (paragraphs BC53–BC87), an adjustment for the time value of money (paragraphs BC88–BC104) and an adjustment for risk (paragraphs BC105–BC120).

BC52 This section discusses:

(a) cash flows that arise from future premiums (paragraphs BC53–BC66).

(b) cash flows that arise from participating features in the contract (paragraphs BC67–BC75).

(c) cash flows that arise from embedded options and guarantees (paragraphs BC76–BC82).

(d) changes in the estimates of future cash flows (paragraphs BC83–BC87).

Cash flows that arise from future premiums (paragraphs 26–29)

BC53 To identify the future cash flows that will arise as the insurer fulfils its obligations, it is necessary to distinguish whether future premiums (and resulting benefits and claims) arise from:

(a) existing contracts (which are included in the measurement of the contract) or

(b) future contracts (which are not included in the measurement of the existing contract).

In other words, it is necessary to draw a contract boundary.

BC54 The essence of a contract is that it binds one or both of the parties. If both parties are bound equally, the boundaries of the contract are generally clear. Similarly, if neither party is bound, it is clear that no genuine contract exists. However, it may be more difficult to determine where the boundaries lie if the contract binds one party more tightly than the other party. The Board focused on common contracts that bind the insurer but not the policyholder, by requiring the insurer to continue to accept premiums but permitting the policyholder to stop paying premiums, although possibly for a penalty.

BC55 Clearly, the point at which the insurer is no longer required to provide coverage and the policyholder has no right of renewal is one point on the boundary of the existing contract. Beyond that point, neither party is bound.

BC56 Similarly, at the point at which the insurer has the right (conferred by the contract) or the practical ability (eg through access to claims information) to reassess the risk presented by a policyholder and, as a result, can set a price that fully reflects that risk, the insurer is no longer bound by the existing contract. Thus, any cash flows arising beyond that point occur beyond the boundaries of the existing contract and should be related to a future contract, not to the existing contract.

BC57 A contract may permit an insurer to reprice a contract on the basis of general market experience (eg mortality experience) but without permitting the insurer to reassess the individual policyholder's risk profile (eg the policyholder's health). In this case, the insurance contract binds the insurer by requiring it to provide the policyholder with something of value (ie continuing insurance coverage without the need to undergo re-underwriting). Therefore, the Board concluded that if the insurer can reprice an existing contract, but cannot at that time reassess the individual policyholder's risk profile, that point lies within the boundary of the existing contract. Thus, the cash flows resulting from that repricing are regarded as arising within the boundaries of the existing contract.

BC58 An insurer may have the right or the practical ability to reassess the risk presented by a policyholder, but not have the right to set a price that fully reflects that risk. In that case, the Board concluded that the contract still binds the insurer. Thus, that point would not lie on the boundary of the

existing contract, unless the restriction on the insurer's ability to reprice the contract is so loose that it is expected to have no commercial substance (ie the restriction has no discernible effect on the economics of the transaction). In the Board's view, if a restriction has no commercial substance, it does not bind the insurer.

BC59 The draft IFRS captures the above conclusions by proposing that the contract boundary is the point at which the insurer is no longer required to provide coverage, or has the right or the practical ability to reassess the risk of the particular policyholder and can set a price that fully reflects that risk. The Board expects that these two tests will often give the same result in practice, but the first test is written in a manner that may be more intuitive for single premium contracts and the second test is written in a manner that may be more intuitive for recurring premium contracts.

BC60 The approach to contract boundaries proposed in the discussion paper is substantially the same as the approach proposed in the draft IFRS, except that the draft IFRS proposes a single test for the contract boundary, whereas the discussion paper proposed two tests depending on whether a contract was onerous:

(a) an onerous test for a contract that is, or has become, onerous—under that test, the insurer would include future premiums from those contracts (and other cash flows, such as claims and policyholder benefits, arising from those premiums) that would result in an increase in the liability.

(b) a guaranteed insurability test for a contract that is not onerous—under that test, the insurer would include those premiums from those contracts (and other cash flows relating to those premiums) that permit the policyholder to continue its coverage without reconfirmation of risk and at a price that is contractually constrained.

BC61 Because of the distinction in the discussion paper between the onerous and guaranteed insurability tests, an insurer would have had to separate the contract cash flows into two buckets. Arguably, the resulting measurement is not the measurement of any real world economic phenomenon. Moreover, performing that separation would have been difficult and costly. In addition, pooling of experience between onerous contracts and non-onerous contracts is a fundamental feature of insurance, and applying different tests would be inconsistent with that fact.

BC62 The Board concluded that defining one test for the boundaries of an existing contract is preferable to an approach that requires one test for an onerous contract and a different test for a contract that is not onerous.

BC63 The discussion paper treated:

(a) all cash flows arising from onerous contracts within a portfolio as arising from the contract.

(b) the additional cash flows captured by the guaranteed insurability test for non-onerous contracts as arising from a customer relationship asset, rather than from the contract. However, rather than recognising and measuring those cash flows separately, the discussion paper proposed including them in the measurement of the insurance contract. Thus, the practical effect was the same as if those cash flows had been regarded as arising from the contract.

BC64 After reviewing the responses to the discussion paper, the Board reconsidered the approach proposed in the discussion paper for the following reasons:

(a) In practice, an insurer might be able to estimate that some contracts within a portfolio have become onerous, but would often not know which contracts are in that category. If the discussion paper's analysis were valid, an insurer could, in principle, write a contract that would transfer to another party those cash flows treated as contractual without at the same time transferring the cash flows treated as non-contractual. However, the insurer could not do that if it does not know which contracts are onerous.

(b) Taken to its logical extreme, the customer-relationship analysis would imply that whenever a liability to a policyholder contains an embedded option, the measurement of the liability should assume that (i) the customer will exercise the option in the way that is least favourable to the issuer and (ii) any offset to the amount for expected 'non-optimal' behaviour by the customer should be recognised as a customer relationship asset, and not included in the measurement of the liability. However, even proponents of the customer-relationship analysis are generally unwilling to carry that analysis through in every case.

(c) The amount that the discussion paper analysed as resulting from a customer-relationship approach does not attempt to represent all of the customer relationship asset (eg possible cross-selling opportunities), but does so only to the extent of cash flows that

arise from contracts in force. Thus, the label 'customer relationship' is not descriptive of what it purports to depict.

BC65 The issue of contract boundaries is related to another question, namely whether an insurer should apply a deposit floor in measuring insurance contracts. The deposit floor is a term often used to describe the following requirement in paragraph 49 of IAS 39:

> The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

BC66 If a deposit floor were applied in measuring insurance contracts, the resulting measurement would ignore all scenarios other than those involving the exercise of policyholder options in the way that is least favourable to the insurer. Such a requirement would contradict the fundamental proposal to incorporate future cash flows on a probability-weighted basis. It would also move the contract boundary forward to the reporting date. Therefore, the proposals in the draft IFRS would not apply a deposit floor in measuring insurance contracts.

Participation features (paragraphs 62–66)

BC67 Some insurance contracts (participating or 'with profits' contracts) give policyholders the right to share in the experience of a portfolio of insurance contracts, specified assets, or both. The insurer can have contractual discretion over the amount or timing of distributions to policyholders, although that discretion is usually subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. Moreover, at inception of the contract, both the insurer and the policyholder typically expect that distributions will be made unless the performance of the underlying portfolio is significantly worse than expected. Such constrained discretion makes it difficult to determine whether the measurement of the liability arising from these contracts should reflect all cash outflows to policyholders that will arise from the existence of those contracts, including those that are discretionary.

BC68 The discussion paper proposed that for participating contracts, the cash flows for each scenario should include an unbiased estimate of the distributions payable to policyholders in that scenario to satisfy a legal or constructive obligation that exists at the reporting date. Some respondents expressed the view that this test could provide an appropriate answer in their circumstances (although not necessarily in other circumstances), but expressed concerns that the Board's liabilities

project (to amend IAS 37) might narrow the definition of a constructive obligation to the point at which it would not permit an appropriate answer for their circumstances.

BC69 However, most respondents indicated that the measurement of a participating insurance contract should include all cash flows from the contract, without any distinction between the participating and non-participating elements. They said that this would be consistent with the proposal in the discussion paper to select current exit value as the measurement attribute, on the basis that market participants would, in assessing the price for a transfer of the contract, consider all cash flows arising from the contract.

BC70 In line with the comments received and for the following reasons, the Board does not propose to limit the cash flows included in the measurement of the liability to those for which a legal or constructive obligation exists.

(a) Including all the cash flows is consistent with the Board's overall view that the measurement of insurance contracts should deal in the same way with all cash flows arising from the contracts.

(b) It can be exceptionally difficult to determine whether an insurer is paying participating benefits because it believes it is obliged to do so, rather than for some other reason that does not normally justify the recognition of a liability, such as to maintain its competitive position or because it believes it is under some moral pressure. Thus, it could be extremely difficult, and perhaps impossible, to make a reasonable estimate of how much would ultimately be enforceable in the unlikely event that an insurer asserts that its discretion to pay or withhold participating benefits is unfettered.

(c) Distributions to participating policyholders can be viewed as a return of excess premiums. Furthermore, premiums for participating contracts are generally set in the expectation, shared by both parties, that the insurer will pay distributions unless performance ultimately is considerably worse than expected. Therefore, it is appropriate to include those distributions in the measurement on the same expected value basis as the premiums.

(d) The participating feature is inversely related to the fixed benefits for the portfolio as a whole. In some scenarios, the fixed benefits will be high and the participating benefits will be low, whereas in other scenarios the fixed benefits will be low and the participating

benefits will be high. If the measurement excludes some of the cash flows that would occur in some scenarios, the resulting measurement will be less consistent and understandable and will provide less relevant information for users.

(e) At initial recognition, if the cash flows exclude the participating benefits that the insurer estimates it would pay in some scenarios, that exclusion will increase the residual margin. As noted in paragraph BC126, the pattern of income recognition for the residual margin is inherently arbitrary and may not be consistent with the timing of policyholder benefits. In contrast, if the cash flows include for each scenario the estimated participating benefits for that scenario, the residual margin will be smaller and the resulting pattern of income recognition will represent the economics of the transaction more faithfully.

(f) Even if a reasonable estimate of non-discretionary cash flows were possible, investors would not benefit from knowing how much might be enforceable in the highly unlikely event that an insurer tried to avoid paying participating benefits in periods when performance would typically permit such benefits to be paid. That amount provides no information about the amount, timing and uncertainty of future cash flows. On the other hand, investors would want to know:

(i) how much of the cash flows will not be available to investors because the insurer expects to pay them to policyholders. The proposed model conveys that information by including those cash flows in the measurement of the liability.

(ii) how much of the risk in the contracts is borne by the policyholders through the participation mechanism and how much by the investors themselves. This information can be conveyed by the required disclosures about risk.

BC71 Some have expressed concerns that the proposed treatment of participating benefits means that the Board does not attach enough importance to the definition of a liability in the conceptual framework. That is not the case. These benefits arise from one component of a contract that, taken as a whole, clearly meets the *Framework*'s definition of a liability. In the Board's view, requiring insurers to devote exceptional efforts to ascertain whether every single piece of that component (if viewed artificially in isolation) meets the definition of a liability would not generate more relevant and representationally faithful information for users and would impose unjustifiable costs.

BC72 Some have expressed concerns that the proposed treatment of participating benefits could lead to a conclusion that preference shares should be classified as liabilities, or might lead to structuring opportunities if entities embed preference shares in insurance contracts. However, the Board notes some significant differences between preference shares and the participating feature in an insurance contract:

(a) The participating feature in an insurance contract is an integral component of a single instrument and is inversely related to the fixed benefits for the portfolio as a whole. If one is high, the other tends to be low. There is no such relationship for preference shares, which are stand-alone instruments.

(b) Preference shares generally confer a right to share in distributions on liquidation and to receive dividends, if declared, during the life of the entity. In contrast, although participating insurance contracts confer a right to share in distributions, if made, this right expires when the contract matures.

BC73 Some participating insurance contracts are issued by mutual insurers and others are issued by investor-owned insurers. The Board has identified no reason to adopt different treatments for these contracts depending on the legal form of the issuer.

BC74 Some respondents to the discussion paper asked the Board to provide specific guidance on amounts that have accumulated over many decades in participating funds and whose 'ownership' may not be attributable definitively between shareholders and policyholders. The Board does not propose such guidance. The proposals would require an insurer to estimate the cash flows in each scenario. If that requires difficult judgements or gives rise to unusual levels of uncertainty, an insurer would consider those matters in determining what disclosures it must provide to satisfy the proposed disclosure objective.

BC75 As described in paragraphs BC198–BC203, the Board proposes that the IFRS should apply to investment contracts with discretionary participation features.

Embedded options and guarantees

BC76 Insurance contracts contain many embedded options and guarantees, for example:

(a) guarantees of minimum investment returns, minimum interest rates or minimum crediting rates, minimum annuity rates or guarantees of maximum charges for mortality.

(b) surrender options, conversion options or options to cease or suspend payment.

(c) options for the policyholder to reduce or extend coverage, or buy additional coverage.

BC77 Inconsistent treatment of embedded options and guarantees was a major flaw in many traditional accounting models. The flaws included:

(a) ignoring the time value of some or all embedded options and guarantees. The time value of such an item is the value arising from the possibility that the option or guarantee may be in the money at the time when it has an effect (eg when the option is exercisable).

(b) capturing the intrinsic value of some or all embedded options or guarantees on a basis that reflects management's expectations or hopes but is inconsistent with current market prices. The intrinsic value of such an item reflects the extent to which the option or guarantee is in the money at the measurement date, and reflects the difference between the current level of the variable underlying the option or guarantee and the level specified in the underlying option or guarantee.

(c) ignoring the intrinsic value of some or all embedded options or guarantees.

BC78 Over the last few years, many accounting approaches for insurance contracts have been adjusted to capture both the intrinsic value and time value of some embedded options or guarantees by requiring insurers to reflect some of these items, generally by accounting for these embedded guarantees or options as if they were free-standing derivatives (an approach often described as bifurcation or unbundling). However, bifurcation approaches often encounter the drawbacks mentioned in paragraph BC41.

BC79 The proposed measurement model for insurance contracts ensures that embedded derivatives are measured in substantially the same way, regardless of whether they are bifurcated, because it achieves the following:

(a) consistency of financial variables (eg discount rates and equity market prices) with observable market prices. The measurement of some embedded derivatives, particularly embedded derivatives that would be bifurcated under existing requirements, relies heavily on

market inputs (eg guaranteed return on an equity index). Consistency with observable market prices is also consistent with the notion of a replicating portfolio (see paragraphs B45–B47).

(b) capturing both the intrinsic value of options and their time value, by using expected values that capture the cash flows arising in each scenario.

(c) inclusion of a risk adjustment. Market valuations of financial instruments reflect the degree of risk associated with the instrument. Including a risk adjustment is conceptually consistent with that fact.

(d) recognising in profit or loss changes in the carrying amount of the derivatives.

BC80 Other factors, for example non-market variables and non-performance risk, are unlikely to cause significant differences between the fair value of embedded derivatives and the result of applying the proposed measurement model for insurance contracts.

BC81 In some cases, some of the cash flows arising from an insurance contract have a risk profile that resembles the risk profile of a free-standing derivative. Sometimes, the most practical way to capture those cash flows in the measurement is to use a replicating portfolio techniques (see paragraphs B45–B47 and BC97). The resulting measurement is unlikely to differ materially from a measurement at fair value.

BC82 The Board concluded that, as part of a consistent approach to unbundling, an insurer should unbundle embedded derivatives that are not closely related to the insurance coverage, applying the existing bifurcation guidance in IAS 39 (see paragraph 12 and paragraphs BC210–BC225 on unbundling).

Changes in the estimates of future cash flows

BC83 The Board concluded that an insurer should recognise the effect of changes in the estimates of cash flows immediately in profit or loss, rather than:

(a) in other comprehensive income (see paragraphs BC171–BC183 for a discussion of other comprehensive income), or

(b) by adjusting the residual margin, as discussed in the following paragraphs.

BC84 The Board considered whether the residual margin should be adjusted when there are changes in the estimates of financial market variables, such as discount rates and equity prices. If the assets backing insurance liabilities are measured at fair value, there would be an accounting mismatch if the residual margin were adjusted for those changes. Therefore, the Board proposes that changes in estimates of financial market variables should be recognised as income or expense. For the same reason, most respondents to the discussion paper agreed that such changes should be recognised as income or expense.

BC85 The Board considered the following approaches to accounting for changes in other estimates, for example mortality rates, lapse rates and expenses:

(a) The changes are recognised immediately in profit or loss and as an adjustment to the insurance liability. The residual margin is unchanged.

(b) The residual margin is adjusted for the changes, both increases and decreases, and the total liability remains unaffected. No expense is recognised.

BC86 Some believe that it would not be a faithful representation of the profit the insurer earns over the time if an insurer recognises income or expense in one period only to reverse it in a later period. They further believe that reporting changes in estimates could be achieved by disclosing period-to-period changes in that margin. Accordingly, those holding this view believe that the residual margin should be adjusted for changes in estimates of non-financial variables. In addition, some believe it is inconsistent to prohibit the recognition of gains at initial recognition on the basis of estimates, but require the subsequent recognition of gains on the basis of similar estimates.

BC87 However, the Board concluded that a current measure of the insurance liability is integral to understanding and reporting insurance contracts. The immediate recognition of all changes in estimates provides important information to users about changes in circumstances for insurance contracts. The Board also concluded that the usefulness of that information is enhanced by presenting changes in estimates as separate items in profit or loss (see paragraphs BC157–BC188). In this respect, disclosure of the changes in estimates is not an adequate substitute for recognising those changes in profit or loss.

Time value of money (paragraphs 30–34)

BC88 This section discusses the following:

(a) Should the measurement of all insurance contracts reflect the time value of money (paragraphs BC89–BC94)?

(b) Should asset-based discount rates be used (paragraphs BC95 and BC97)?

(c) Should the discount rate for an insurance liability reflect liquidity factors (paragraphs BC98–BC104)?

Time value of money for all insurance contracts?

BC89 Entities are not indifferent to the timing of cash flows. An amount payable tomorrow is not equivalent to the same amount payable in ten years. In other words, money has a time value. The Board proposes that the measurement of all insurance contracts should reflect the time value of money, because that more faithfully represents the insurer's financial position.

BC90 Some respondents to the discussion paper suggested that insurers should not discount their non-life (property and casualty) insurance contract liabilities. In their opinion, measuring non-life insurance contracts at a discounted amount would produce information that is less reliable because non-life insurance contracts are more uncertain than life insurance contracts with respect to:

(a) whether the insured event will occur (whereas the insured event in a life insurance contract is certain to occur unless the policy lapses);

(b) the amount of the future payment that would be required if an insured event occurs (whereas the amount of the future payment obligation is generally specified in, or readily determinable from, a life insurance contract); and

(c) the timing of any future payments required because of the insured event (whereas the timing of future payments in a life insurance contract is typically more predictable).

BC91 These uncertainties mean that the cash flows for many non-life insurance contracts are less predictable than for many life insurance contracts. Those commentators believe that estimating the timing of payments and determining a discount rate would introduce additional subjectivity to the liability measurement, and that this could reduce comparability and

permit earnings management. Furthermore, they believe that the benefits of presenting a discounted measure of those insurance liabilities may not justify the costs to prepare that measurement. They believe that the timing of cash flows (and, therefore, interest) is an essential component of the pricing and profitability of life insurance contracts, but is less relevant for non-life insurance contracts because the commentators view underwriting results as the most critical component of the pricing and profitability of those contracts.

BC92 These arguments did not persuade the Board. As noted in paragraph BC89, insurers and investors are not indifferent to the timing of cash flows, and so measuring an insurance liability using undiscounted cash flows would not faithfully represent the insurer's financial position and would be less relevant to users. The Board also concluded that:

(a) discount rates and the amount and timing of future cash flows can generally be estimated in a sufficiently reliable and objective way at a reasonable cost. Absolute precision is unattainable, but it is also unnecessary. Discounting can be applied in a way that leads to measurements within a reasonably narrow range and results in more relevant information for users. Furthermore, many entities have experience in discounting, both to support investment decisions and to measure items for which IFRSs require discounting (eg employee benefit obligations and long-term non-financial liabilities).

(b) in some cases, discounted measures may be more reliable, and less subjective, than undiscounted measures. When measurements include the effect of inflation explicitly or implicitly, insurers need to estimate the timing of payments. The effect of the time value of money tends to offset much of the effect of inflation, and variations in estimates of cash flows far in the future are smaller when reduced to their present values.

BC93 Some commentators suggested that measuring non-life insurance contract liabilities at undiscounted amounts that ignore future inflation could provide a reasonable approximation of the value of the liability (especially for short-tail liabilities), and at less cost and complexity than explicit discounting. However, this approach of implicitly discounting the liability makes the unrealistic assumption that two variables (claim inflation and time value) will more or less offset each other in every case. For that reason, the Board concluded that financial reporting will be improved if insurers estimate those effects separately.

BC94 For cost-benefit reasons, the Board proposes a modification to the measurement approach for application to the pre-claims period of some short-duration insurance contracts. This is discussed in paragraphs BC145–BC148.

Asset-based discount rates

BC95 Some existing accounting approaches discount insurance liabilities using discount rates derived from the expected return on assets backing the liabilities. Proponents of that technique believe that:

(a) it is consistent with some pricing practices;

(b) it prevents large losses at inception for some contracts that are expected to be profitable and so reflects the most likely outcome of the insurance activity as a whole, considering the underwriting and investment functions together; and

(c) it avoids the volatility that would arise if short-term fluctuations in asset spreads affect the measurement of the assets, but not the measurement of the liabilities. Because an insurer holds those assets for the long term to enable it to fulfil its obligations under the insurance contracts it has issued, some believe that those fluctuations make it more difficult for users of an insurer's financial statements to assess the insurer's long-term performance.

BC96 However, the Board rejected asset-based rates because those rates are irrelevant for a decision-useful measurement of the liability, unless the cash flows from the assets affect the cash flows arising from the liability.

BC97 The cash flows from assets affect the cash flows arising from the liability in unit-linked and some participating contracts. In those cases, the Board believes that an insurer would capture that linkage by using replicating portfolio techniques, or techniques that have similar outcomes (see paragraph 32). A replicating portfolio is a portfolio of assets providing cash flows that exactly match the cash flows from the liability in all scenarios. If such a portfolio exists, the appropriate discount rate(s) for the replicating portfolio would also be the appropriate discount rate(s) for the liability. If a replicating portfolio exists and can be measured directly, there is no need to use a building block approach for the part of the liability that is replicated by that portfolio. The measures of the replicating portfolio and the replicated cash flows arising from the liability are identical.

Liquidity

BC98 Discussions of the time value of money often use the notion of risk-free rates, generally described as observable market rates for highly liquid government bonds. However, there is an important difference between such bonds and many insurance liabilities. Government bonds are often traded in highly liquid markets and the holder often can sell such bonds in the market at short notice, without incurring significant costs and without affecting the market price. In contrast, for many insurance contracts, the policyholder cannot sell the contract to a third party and cannot put it back to the insurer, or perhaps can do so, but only by paying a significant penalty.

BC99 Said differently, the holder of a typical government bond acquires two things, a holding in an underlying non-tradable investment (paying a return higher than the observed return on the traded bond) and an embedded option to sell the investment (for which the holder pays an implicit premium through a reduction in the overall return). Thus, for a liability that the holder cannot sell or put (or can do so only at significant cost), the discount rate should equal the return on the underlying non-tradable investment, with no deduction for the premium on the embedded put option, because no such put option is present in the liability.

BC100 The Board concluded that, in principle, the discount rate should reflect the liquidity characteristics of the item being measured. The Board then considered input from preparers of financial statements, academics and regulators on how such a liquidity premium can be measured.* That input suggests that there is not yet a consensus on how best to measure those effects, for example how to separate liquidity effects from credit effects. Concerns about those issues became greater during the financial crisis of recent years, as spreads widened dramatically.

BC101 The Board believes that it would not be appropriate, in a principle-based approach:

(a) to provide detailed guidance on how to estimate liquidity adjustments.

(b) to prescribe a discount rate that ignores the liquidity characteristics of the item being measured or uses an arbitrary benchmark (eg high quality corporate bonds) as an attempt to develop a practical proxy for measuring the specific liquidity characteristics of the item being measured.

* See for example Committee of European Insurance and Occupational Pensions (CEIOPS) Task Force on the Illiquidity Premium (2010): Report. Ref. CEIOPS-SEC-34/10, 1 March 2010.

BC102 In developing the draft IFRS, the Board considered concerns raised by some commentators about the discount rate, particularly for long-duration non-participating insurance contracts. Those concerns include the following items mentioned in paragraph BC95:

(a) the possibility of significant losses at the inception of some contracts.

(b) possible accounting mismatches if the discount rate for insurance contracts does not change in response to changes in market credit spreads.

BC103 The Board discussed whether those concerns would diminish if the Board revisited its previous decision that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer. After the discussion, the Board did not change that decision but would welcome views on this issue.

BC104 As noted above, there are some difficult conceptual and practical issues relating to the discount rate for insurance contracts. The Board intends to continue its investigation of these issues during the period for comment on the exposure draft. Among other things, the Board intends to seek further input from the insurers that have participated in the field testing exercise.

Depicting risk and uncertainty

BC105 In the draft IFRS, the Board proposes to depict the risk and uncertainty inherent in insurance contracts by including a risk adjustment in the measurement of those contracts. The risk adjustment directly measures the remaining risk in the contract. The measurement of an insurance contract also includes a residual margin (see paragraphs BC124–BC133) to depict the profitability of the contract over time. The residual margin is determined at inception and is calculated as an allocated amount of the consideration received or receivable from the policyholder. This approach of including both a risk adjustment and a residual margin in the measurement of an insurance contract can be referred to as a 'two-margin' approach.

BC106 The FASB and some Board members would prefer to depict risk and uncertainty in the insurance contract within a single composite margin. They consider that the relative benefits of the two-margin approach over a composite margin approach (explained below in paragraphs BC109–BC115) do not outweigh the additional costs of implementation. As explained in

the Appendix, the main difference between the approaches is that, in contrast to the two-margin approach, the composite margin would not identify a separate, explicit risk adjustment in the measurement of an insurance contract.

BC107 Both the two-margin approach and the composite margin approach have advantages and disadvantages. Consequently, the Board would particularly welcome views from respondents on both approaches and will continue its discussions when it is finalising the proposed IFRS.

Risk adjustment (paragraphs 35–37)

BC108 This section discusses:

(a) the reasons for including a risk adjustment in the measurement of an insurance contract.

(b) the techniques for estimating the risk adjustment.

(c) the level of aggregation for risk adjustments.

Reasons for including a risk adjustment in the measurement of an insurance contract

BC109 The draft IFRS proposes that the risk adjustment should depict the maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. In the Board's view, the resulting measurement would:

(a) convey useful information to users about the amount of risk associated with the insurer's insurance contracts because the management of risk is integral to the insurance business model.

(b) reflect the insurer's view of the economic burden imposed on it by the presence of that risk.

(c) be broadly consistent with existing requirements in IAS 37, and with the refinements of, and extensions to, those requirements proposed in the exposure draft *Measurement of Liabilities in IAS 37*.

(d) reduce the amount of the residual margin for which a release pattern is somewhat arbitrary.

BC110 The Board thinks that a risk adjustment should not represent:

(a) the compensation a market participant would require for bearing the risk associated with the contract. As noted in paragraphs BC49 and BC50, the objective of the measurement model is not current

exit value or fair value and therefore does not reflect transfer to a market participant. Therefore, the risk adjustment should not be determined as the amount of compensation a market participant would require.

(b) an amount that would provide a high degree of certainty that the insurer would be able to fulfil the contract. Although such an amount might be appropriate for regulatory purposes, it is not compatible with the Board's objective of providing information that will help users of financial statements make economic decisions.

BC111 Some oppose the inclusion of a risk adjustment in the present value of fulfilment cash flows, for the following reasons:

(a) No single technique for developing risk adjustments is universally used and accepted. The co-existence of a range of methods would limit comparability across insurers.

(b) Some techniques are difficult to explain to users and, for some techniques, it may be difficult to provide clear disclosures that would give users an insight into the inner workings of the technique.

(c) Although practitioners may, in time, develop intuitions that help them assess whether the amount of a risk adjustment is appropriate for a given fact pattern, it is not possible to perform direct back-tests to assess retrospectively whether a particular adjustment was reasonable. Over time, an insurer may be able to assess whether subsequent outcomes are in line with its previous estimates of probability distributions. However, it would be difficult, and perhaps impossible, to assess whether, for example, a decision to set a confidence level at a particular percentile was appropriate.

(d) Developing systems to determine risk adjustments will involve cost, and some doubt whether the benefits will be sufficient to justify the cost.

(e) The inclusion of an explicitly measured risk adjustment is inconsistent with the Board's proposals on revenue recognition, whereas the use of a single composite margin is more consistent with those proposals.

(f) If the remeasurement of the risk adjustment for an existing portfolio of contracts results in a loss, that loss will reverse in later

periods as the insurer is released from that risk. Reporting a loss followed by an inevitable reversal of that loss may confuse some users.

BC112 However, the Board proposes to require a separate risk adjustment because it believes that this:

(a) results in an explicit measurement of risk that will provide a clearer insight into the core activity of an insurer.

(b) reduces the amount that needs to be released to income using the inherently somewhat arbitrary mechanisms used to release the composite or residual margin.

(c) is conceptually consistent with market valuations of financial instruments and their pricing, which indisputably reflect the degree of risk associated with the instrument.

(d) ensures that the measurement of an insurance liability includes a margin, which is essential to distinguish risk-generating liabilities from risk-free liabilities. In contrast, a single composite margin reflects the insurer's pricing policy and may not correspond to the degree of risk present in the liability both at inception and throughout the contract term.

BC113 There is an important conceptual difference between the two approaches. The composite margin and the residual margin that the draft IFRS would include in the measurement of an insurance contract are both allocations of an amount determined at inception, and they decline over time in accordance with a specified release pattern (see paragraphs BC125–BC129). In contrast, the risk adjustment is an explicit remeasurement at the end of each reporting period and can, in principle, either increase or decrease at the end of each period.

BC114 However, that conceptual difference will not always have a large practical effect. This is because the risk adjustment will typically decline over time (although, on occasion, it may increase temporarily, for example if a life insurer is uncertain whether a rise in influenza rates reflects normal seasonal variation or the early signs of a pandemic). When that is the case, the two-margin approach (risk adjustment and a separate residual margin) has an effect similar to splitting the initial margin into two components and using a different driver to release each component to income. The resulting release pattern is more sensitive to the economic drivers of the contract, but implementing that approach may be more costly.

BC115 The two-margin approach has one other important practical consequence. That approach is more likely to generate a loss at the initial recognition of an insurance contract. For example, suppose that the expected present value of the net cash flows over the coverage period is a net cash inflow of CU100 (resulting from premium inflows with an expected present value of CU1,000 and policyholder benefit outflows with an expected present value of CU900) and the risk adjustment is CU130. Under the two-margin approach, the insurer would recognise a loss of CU30 at inception. Subsequently, the insurer would recognise income of CU130. In contrast, under the composite margin approach, the initial measurement of the contract would include a composite margin of CU100 and the insurer would recognise no loss at inception. Subsequently, the insurer would recognise income of CU100.

Techniques for estimating the risk adjustment

BC116 The Board proposes to limit the number of permitted techniques to determine the risk adjustment. The Board selected three techniques that it believes are reasonably widely understood, applied in practice to some extent, and capable of providing relevant information consistent with the proposed objective for the risk adjustment. The Board considered the view that:

(a) limiting the number of techniques would conflict with the Board's wish to set principle-based standards.

(b) in particular situations, some techniques may be more applicable, or may be easier to implement. It may not be practicable for an IFRS to specify in detail every situation in which particular techniques would be appropriate.

(c) techniques may evolve over time. Specifying particular techniques might prevent the use of new techniques that are more suitable.

BC117 However, the Board concluded that permitting a wide range of techniques to determine the risk adjustment could lead to diversity in practice, which might reduce the relevance of the resulting measurement and make it difficult for users to compare risk adjustments made by different insurers. Accordingly, the draft IFRS proposes:

(a) to state a principle for determining the risk adjustment.

(b) to specify that only three techniques are permitted as a means of complying with that principle, and to provide guidance to help insurers assess when each of those techniques is more likely to be appropriate.

(c) that an insurer should translate its risk adjustments into a confidence level for disclosure, even if the insurer has used one of the other two permitted techniques to determine the risk adjustment. That disclosure would enhance comparability among insurers.

Level of aggregation for risk adjustments

BC118 Each of the permitted techniques for measuring risk adjustments builds on a probability distribution of the underlying cash flows. The shape of that distribution depends on the level at which the insurer determines the risk adjustments (eg for a contract, for a portfolio, for a legal entity or for the reporting entity as a whole). Therefore, the Board proposes to specify the level of aggregation for the risk adjustment.

BC119 The Board considered the following levels of aggregation:

(a) Determining risk adjustments at the level of individual contracts. However, this approach would contradict the rationale of insurance, which is to pool risks by grouping similar contracts into a portfolio.

(b) Determining risk adjustments directly for a legal entity or for the entire reporting entity. However, this approach would require the insurer to undertake one of the following:

(i) to assume that all portfolios within that entity are fungible, ie that a surplus in one portfolio is available in full to cover a deficit in another portfolio. In the Board's view, this would be inappropriate because complete fungibility is rare in practice, for legal and regulatory reasons.

(ii) to consider the degree of fungibility in estimating the probability distribution. In the Board's view, this would be a difficult and burdensome exercise and would be so reliant on difficult judgements that it would not produce information that is relevant or represents faithfully the degree of fungibility that exists.

(c) Determining risk adjustments at the level of individual portfolios. The Board concluded that this is the most practical solution and the most likely to produce relevant information for users at reasonable cost. Because the portfolio contains reasonably homogeneous contracts, it is the most natural level at which to estimate the probability distribution of the cash flows. Furthermore, although an insurer might expect to derive some

diversification benefits by grouping together various portfolios, determining the extent of those benefits is difficult because of the lack of full fungibility between portfolios.

BC120 In view of the above considerations, the Board proposes that an insurer should determine risk adjustments for a portfolio of contracts that are subject to broadly similar risks and managed together as a single pool. The Board acknowledges that this description of a portfolio is not fully rigorous, but it believes that a more rigorous definition is not attainable and that this description will provide information that is relevant to users and faithfully represents the extent of risk, at a reasonable cost.

Day 1 gains

BC121 The residual margin is calibrated at inception to an amount that precludes the recognition of a net gain at initial recognition of an insurance contract. A 'day 1' gain might arise when the expected present value of cash outflows required to fulfil the insurance contract is less than the expected present value of the consideration received or receivable. However, the Board concluded that an insurer should not recognise a day 1 gain because:

(a) it would be inconsistent with the proposals in the exposure draft *Revenue from Contracts with Customers*. At inception, the insurer has not satisfied any of its performance obligations.

(b) there may be a risk that the amount identified as a day 1 gain has been identified incorrectly, and has arisen from an error in measuring the insurance contract liability.

Day 1 losses

BC122 The Board noted that a loss could arise at contract inception. The Board believes that recognising a loss at inception is appropriate if the amount paid by the policyholder is insufficient to cover the expected present value of the policyholder benefits and claims and also to compensate the insurer adequately (as measured by the risk adjustment) for bearing the risk that the policyholder benefits ultimately exceed the expected premiums paid by the policyholder. The residual margin is an allocation of part of the premium provided by the policyholder. Because it is an allocation, it cannot be negative, either at inception or subsequently.

BC123 As noted in paragraph BC115, a loss is more likely to arise under the two-margin approach than under the composite margin approach. Furthermore, including a risk adjustment in identifying a loss at initial recognition is inconsistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, but it is consistent with the treatment of financial instruments issued on off-market terms. The Board believes that including a risk adjustment in the measurement of insurance contracts is essential to portray the economics of insurance contracts.

Residual margin

BC124 This section discusses the following:

(a) the release to income of the residual margin.

(b) the level of aggregation for the residual margin.

(c) accretion of interest on the residual margin.

Release of residual margin (paragraph 50)

BC125 The residual margin could be viewed as an aggregation of several factors, including:

(a) compensation for the cost and effort of originating the contracts and assembling them into the portfolio.

(b) compensation for providing ancillary services that are not unbundled (and so are not treated as arising from a separate service contract within the scope of standards on revenue recognition).

(c) compensation for product development.

(d) additional returns if the insurer has significant pricing power, or conversely discounts if the insurer is seeking to build or maintain market power.

(e) the risk that the insurer might not satisfy its obligation to perform under the contract.

BC126 The draft IFRS does not propose that an insurer should measure any of those factors separately. Instead, the Board's objective is to seek a release pattern that corresponds in a reasonable way and at an acceptable cost to the pattern of the factors that generated those margins at initial recognition. Because those margins are a blend of various factors not separately identifiable, any such release pattern inevitably will be

arbitrary to some extent. Because the risk adjustment reflects the risk in the contract, the Board thinks that risk should not drive the release pattern for the residual margin (unless risk is used as a convenient and reasonable proxy for another factor).

BC127 Instead, the Board proposes to determine the release pattern for the residual margin on the basis of an insurer's performance under the contract. Since insurance risk is present in every insurance contract and the insurance coverage from this type of risk represents a predominant factor for the performance under the insurance contract, the Board believes that the insurance coverage can be used as the basis for release across all types of contracts.

BC128 The Board believes that the factors implicitly included in the margin would no longer be relevant after the end of the coverage period. Therefore, the Board proposes that the residual margin should be recognised as income over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of passage of time, but

(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

BC129 The draft IFRS proposes that the residual margin recognised in profit or loss for the period should be adjusted to reflect the portion of any contracts that are no longer in force at the end of the reporting period. This is consistent with recognising the residual margin over the coverage period of a contract. For similar reasons, no adjustment should be made if more contracts than expected are in force at the end of the period.

Level of aggregation for the residual margin

BC130 Paragraph BC120 explains that the risk adjustment should be determined at a portfolio of contracts level that groups together contracts subject to similar circumstances (ie contracts that are subject to similar risks and are managed together as a pool). However, because the residual margin is released over the coverage period, it is necessary to adopt a different level of aggregation for residual margins that group together only those contracts within the portfolio that have similar coverage periods. For that reason, the Board concluded that residual margins should be determined at a level that aggregates insurance contracts into a portfolio

and, within each portfolio, by similar date of inception of the contract and by similar coverage period. An alternative would be to determine the release of the residual margin at an individual contract level, but the Board concluded that would be impracticable.

Accretion of interest on the residual margin (paragraph 51)

BC131 Interest is accreted on a risk adjustment because the adjustment is always a current measure and so implicitly or explicitly reflects the time value of money. The draft IFRS proposes that interest also should be accreted on the residual margin for the following reasons:

(a) At initial recognition, the residual margin can be viewed as an allocation of part of the transaction price, ie consideration paid or payable by the insurer's customer (the policyholder). Accreting interest is consistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, which would require an entity to accrete interest on the transaction price (if material). The accretion of interest reflects the fact that the entity would rationally have charged a different cash amount if the contract had stipulated earlier or later payment by the customer. Thus, accretion of interest shows the effect of the financing separately from the revenue from goods or services.

(b) The residual margin is one part of an overall measure of the insurance contract and every other component of that measure reflects the time value of money, leading to subsequent accretion of interest. The accretion of interest on the residual margin is consistent with that fact.

BC132 Because the residual margin is determined at inception and not adjusted subsequently, the Board proposes that the interest rate used to accrete interest on the residual margin would be locked in at inception of the contract and not adjusted subsequently. Furthermore, the rate would be the discount rate used to discount the cash flows included in the measurement of the liability.

BC133 The Board considered the view of some who do not believe interest should be accreted on the residual margin, on the grounds of simplicity and because they view the residual margin as a deferred credit rather than as a representation of a component of an obligation. That view is supported by the FASB and applied to the composite margin in the FASB's preferred approach (see Appendix). However, the Board did not find that view persuasive.

Other measurement issues

BC134 The draft IFRS also contains proposals for the treatment of:

(a) acquisition costs.

(b) insurance contracts acquired in a portfolio transfer or business combination.

(c) the pre-claims liability of short-duration contracts.

(d) foreign currency.

Acquisition costs (paragraph 39)

BC135 Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract. These costs are commonly referred to as acquisition costs. An insurance contract is generally priced to recover those costs through future premiums and surrender charges.

BC136 The measurement approach proposed in the discussion paper and in the draft IFRS represents a change from many existing accounting models that measure insurance liabilities initially at the amount of the premium received, with deferral of acquisition costs. Such models treat acquisition costs as representing the cost of a recognisable asset, which, depending on the model, might be described as a contract asset or a customer relationship intangible asset. The Board thinks that the pressure to recognise such an item as a separate asset arises from an overstatement of the insurer's obligation. In essence, the insurer typically charges the policyholder a price that the insurer regards as sufficient to compensate it for two things: (a) undertaking the obligation to pay for insured losses and (b) the cost of originating the contracts. Thus, a faithful representation of the remaining obligation should not include the part of the premium that paid for the incremental acquisition costs.

BC137 In addition, deferring acquisition costs as an asset would report an asset that either (a) does not exist (if the insurer recovers acquisition costs from cash already received) or (b) relates to future cash flows that should be included in the measurement of the contract. Consequently, the discussion paper proposed that an insurer should recognise acquisition costs as an expense, not as the cost of an asset, and should recognise revenue at an amount equal to the portion of the premium that relates to recovering its acquisition costs. Respondents generally agreed that acquisition costs should not typically result in a loss at initial recognition of an insurance contract (unless the contract is onerous).

BC138 In subsequent discussions, the Board achieved a similar outcome, but by a different route. The Board now proposes that the incremental acquisition costs incurred by the insurer should be included in the contract cash outflows. This reduces the residual margin at initial recognition of the contract. If the contract pricing is insufficient to recover all of the incremental acquisition costs, a loss will arise at initial recognition, because the residual margin cannot be negative.

BC139 The Board proposes that the contract cash flows should include only those acquisition costs that are incremental to an individual insurance contract. Some may disagree with that conclusion because they believe that:

(a) an insurer typically will price an insurance contract to recover not only incremental costs, but also other direct costs and a proportion of indirect costs; and

(b) the definition of incremental acquisition costs is too narrow to reflect adequately the various sales structures of insurers—for instance, it may result in different answers for sales structures that have the same cost level but use different channels (eg external agents versus direct writing).

BC140 The Board proposes to limit the acquisition costs to be included in the cash flows to incremental costs because those costs can be clearly identified as relating specifically to the contract. Determining whether other costs are directly related to the contract can be more subjective. Furthermore, focusing on incremental costs is consistent with how IAS 39 and IFRS 9 determine the transaction costs of financial instruments. It is also consistent with the approach to costs of securing a right to provide investment management services, as described in paragraph 14(b)(iii) of the illustrative examples accompanying IAS 18 *Revenue*. (However, under the proposals in the exposure draft *Revenue from Contracts with Customers*, that right would no longer be recognised as an asset, and the incremental costs of securing it would be recognised as an expense.)

Insurance contracts acquired in a portfolio transfer or business combination (paragraphs 40–42)

BC141 When an insurer assumes an insurance liability in a portfolio transfer, it typically receives consideration from the transferor. The Board concluded that the insurer should treat that consideration in the same way as a premium received at initial recognition. In other words:

(a) if the consideration received exceeds the present value of the other fulfilment cash flows (outflows less inflows), the excess establishes the residual margin at initial recognition of the insurance liability.

(b) if the present value of the other fulfilment cash flows (outflows less inflows) exceeds the consideration received, the insurer should measure the insurance liability initially at that higher amount and should not add a residual margin. Instead, the difference between the initial measurement of the liability assumed and the consideration received would be recognised immediately as an expense at initial recognition.

BC142 Similarly, when an entity assumes a liability in a business combination, it measures that liability initially at fair value, with limited exceptions specified in IFRS 3 *Business Combinations*. That fair value may be viewed as representing a portion of the total consideration for the business combination, namely the portion relating to the liability assumed. In other words, the fair value of the portfolio of insurance liabilities may be viewed as corresponding to the fair value of the consideration received. Applying that notion to a portfolio of insurance liabilities assumed in a business combination leads to the following conclusions:

(a) If the fair value of the portfolio exceeds the present value of the fulfilment cash flows (outflows less inflows), the excess establishes the residual margin at initial recognition of the portfolio of insurance liabilities.

(b) If the present value of the fulfilment cash flows (outflows less inflows) exceeds the fair value of the liability, the insurer should measure the portfolio of insurance liabilities initially at that higher amount and should not add a residual margin.

BC143 The proposal described in paragraph BC142(b) means that an insurer would never recognise the portfolio of insurance liabilities at less than the present value of the fulfilment cash flows. Moreover, the initial measurement of that portfolio at that higher amount will affect the initial measurement of goodwill. Although this proposal would require a new measurement exception in IFRS 3, similar exceptions are contained in IFRS 3 for other cases in which liabilities, such as pension liabilities, are measured continuously on a current value basis that is not fair value.

BC144 The Board considered how the present value of the fulfilment cash flows could exceed the consideration received in exchange for a portfolio transfer or might exceed the fair value of the portfolio of insurance contracts acquired in a business combination. The most likely cause is the fact that the present value of the fulfilment cash flows does not

consider the risk of non-performance by the insurer. The Board concluded that the immediate recognition of a loss in such circumstances faithfully represents the fact that the insurer has acquired an obligation that it expects to fulfil, but received a lower price because it might not be able to fulfil the obligation.

Modified measurement for the pre-claims liability of some short-duration contracts (paragraphs 54–60)

BC145 The Board proposes that the pre-claims liability arising from some short-duration contracts (ie contracts for which the coverage period is approximately one year or less, and meeting other conditions specified in paragraph 55) should be measured using an unearned premium approach, unless the contract is onerous. Such an approach is consistent with the customer consideration approach proposed in the exposure draft *Revenue from Contracts with Customers*.

BC146 The Board believes that when the pre-claims period is approximately one year or less and provided that the contract contains no significant embedded derivatives, the unearned premium is a reasonable approximation of the present value of the fulfilment cash flows and the residual margin (and achieves a similar result at a lower cost). This is because if significant changes in estimates are made during the coverage period of a short-term duration contract, those changes are more likely to be unfavourable (leading to losses) than favourable (leading to gains). The insurer would recognise these losses because of the requirement to recognise an additional liability when the contract becomes onerous. Thus, requiring an insurer to apply the full measurement model for these contracts would not generate sufficient benefits to justify the costs of adopting the new approach.

BC147 The Board considered whether the modified approach should be permitted but not required. Proponents of that view argue that the modified approach is intended to provide a practical short cut that combines the strengths of the approach now proposed for insurance contracts in general with the virtues of existing approaches for these contracts; for these contracts, they believe that the incremental benefits of switching fully to the new model are not sufficient to justify the costs. Those proponents argue that requiring insurers to use that short cut rather than merely permitting them to do so is inconsistent with the rationale for the short cut. However, to ensure comparability between the financial statements of different insurers, the Board proposes to require insurers to apply the modified measurement approach to all short-duration contracts that meet the specified conditions.

BC148 To maintain consistency with the measurement for insurance contracts generally, the modified approach also includes the following features:

(a) The pre-claims obligation and the expected present value of the future premiums are presented as a single insurance contract asset or liability (see paragraph BC156).

(b) Interest is accreted on the insurance contract asset or liability, if the effect of the time value of money is material.

(c) The basis for the onerous contract test is the present value of the fulfilment cash flows, which is the measurement for insurance contracts generally. Considering the short duration of the coverage period, the level of aggregation for the onerous contract test would be within the portfolio of insurance contracts, by similar date of inception.

(d) The incremental acquisition costs are deferred and presented as a deduction from the part of the premium allocated to the remaining coverage period. Those deferred incremental acquisition costs would be recognised as an expense over time in a pattern consistent with the pattern in which the premium is recognised as revenue.

Foreign currency (paragraph 61)

BC149 The draft IFRS proposes that an insurance contract should be treated as a monetary item for foreign currency translation in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

BC150 Insurers applying IFRS 4 typically treat an unearned premium for an insurance contract that is denominated in a foreign currency as a non-monetary item. However, treating the unearned premium as a non-monetary item causes an accounting mismatch to arise if, for example, the premium is held in a bank account denominated in foreign currency (and thus is classified as a monetary item) and the insurer expects to use part of that premium to pay claims denominated in that foreign currency. In that example, the carrying amount of the premium would reflect subsequent changes in the exchange rate, whereas the carrying amount of the non-monetary insurance liability would remain unchanged. The Board believes that because the proposed measurement model focuses on estimates of future cash flows, it would be more appropriate to view an insurance contract as a whole as a monetary item.

BC151 IAS 21 would classify the insurance contract components relating to the expected present value of cash flows and the risk adjustment (which is determined by the amount, timing and uncertainty of those cash flows) as monetary items, but might classify the residual margin component as non-monetary because it is similar to prepayments for goods and services. However, the Board believes that it would be a more faithful representation of the transaction to treat all components of the measurement of insurance contract denominated in a single currency as a monetary item, and therefore retranslate them as exchange rates change.

BC152 For the same reasons, the Board proposes that insurance contracts measured using the modified approach for short-duration contracts would also be a monetary item.

Assets underlying unit-linked contracts

BC153 The Board discussed accounting mismatches that arise today from the measurement of unit-linked contracts, focusing on the following items held in funds underlying such contracts:

(a) the insurer's own shares. An accounting mismatch arises for these items today because they are not recognised as assets under IAS 32.

(b) property occupied by the insurer. An accounting mismatch arises today for such property because IAS 16 *Property, Plant and Equipment* would treat it as owner-occupied. As a result, although the insurer would be able to measure that property at fair value, it would recognise changes in the property's fair value in other comprehensive income, not in profit or loss.

BC154 The Board concluded that these accounting mismatches make an insurer's financial statements less relevant to users and less understandable, resulting in a less faithful representation of the insurer's financial position and financial performance. Therefore, the Board proposes:

(a) to eliminate those mismatches by requiring the insurer to recognise these items, including the insurer's own shares, as assets and measure them at fair value through profit or loss to the extent those changes relate to the interest of unit-linked contract holders in the pool of assets (see Appendix C to the draft IFRS).

(b) that if the insurer also has its own interest in the same fund, the insurer should measure those assets at fair value. However, in the case of property, changes in the fair value of the insurer's own

interest in the property would be recognised in other comprehensive income as a revaluation.

BC155 To improve comparability, the Board proposes to require that treatment, not merely to permit it. However, the Board does not intend to introduce a requirement for insurers to measure all financial assets underlying unit-linked contracts at fair value through profit or loss, if that would not otherwise be required by IFRS 9 or IAS 39.

Presentation (paragraphs 69–78)

Statement of financial position (paragraphs 69–71)

BC156 The draft IFRS proposes that the combination of rights and obligations arising from an insurance contract is presented as a single insurance contract asset or liability in the statement of financial position, consistently with the measurement of an insurance contract asset or liability based on a package of cash inflows and outflows. Such presentation is consistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, which treat the combination of rights and obligations as giving rise to a single contract asset or liability.

Statement of comprehensive income (paragraphs 72–78)

BC157 The Board proposes a presentation model for reporting income and expense arising from insurance contracts that is consistent with the proposed measurement model by reporting the changes in the building blocks that make up the measurement of the insurance contract. Such a presentation would provide users with useful information about important performance factors. Accordingly, the statement of comprehensive income should provide information about:

(a) the change in the risk adjustment.

(b) the release of the residual margin.

(c) the difference between the actual cash flows for the current period and previous estimates of those cash flows.

(d) changes in estimates (remeasurements) during the period.

(e) interest expense on insurance liabilities (ie the 'unwinding' of the discount), presented or disclosed in a way that highlights the relationship between interest expense, changes in discount rates and investment return on the assets that back those liabilities.

BC158 The Board considered two approaches for presenting income and expenses arising from insurance contracts: a margin approach and a premium approach.

Margin approaches

BC159 A margin approach presents changes in the risk adjustment and the release of the residual margin as important performance measures for an insurer.

BC160 The draft IFRS proposes a margin approach that views all cash inflows associated with an insurance contract as deposits received from the community of policyholders and all the cash outflows as repayments to the community of policyholders. Some refer to this approach as a 'summarised margin approach' because it does not present any items of income or expense relating directly to those cash flows. The draft IFRS proposes enhanced disclosure to provide users with information on premiums, claims and expenses (see paragraph BC167).

BC161 The summarised margin approach follows the structure of the information in paragraph BC158 by separately reporting:

(a) income from the insurer's performance under the contract as it is released from risk (decrease in risk adjustment) and as it provides insurance coverage (release of the residual margin).

(b) changes in circumstances as they occur, and any differences between estimates at the end of the previous reporting period and actual outcomes.

(c) the interest expense on insurance liabilities, presented or disclosed in a way that highlights the relationship with changes in discount rates and with the investment return on the assets that back those liabilities.

BC162 In the Board's view, a summarised margin approach has the following advantages:

(a) It links clearly with the measurement approach for the insurance liability in the statement of financial position. Failure to illustrate such linkages is a significant defect of many existing models, particularly for long-duration contracts.

(b) It makes it unnecessary to unbundle deposit receipts from the premiums because it treats premiums in the same way as deposits. Many longer-term life insurance contracts contain deposit

components. Drawing a line between the deposits and the premiums may be somewhat arbitrary for some contracts.

BC163 However, the summarised margin approach does not provide information in the statement of comprehensive income about the amount of premiums and claims. Most respondents to the discussion paper viewed all premiums as revenue, especially for non-life insurance contracts. Furthermore, the summarised margin approach does not present revenue as defined in the exposure draft *Revenue from Contracts with Customers* because the summarised margin approach depicts as income only part of the total consideration receivable from the policyholder, namely the risk adjustment at initial recognition, and the residual margin. Accordingly, the income presented in the statement of comprehensive income would not be comparable with presentation approaches for revenue from other activities, such as fund management.

BC164 The Board considered an approach that expands the summarised margin approach to provide information about premiums and claims (the 'expanded margin' approach). In the expanded margin approach, the insurer presents in profit or loss both changes in the risk adjustment and the release of the residual margin during the reporting period, and some or all of the policyholder claims and benefits and other expenses.

BC165 However, in some cases, the revenue recognised using the expanded margin approach would not be determinable directly, but would need to be imputed by 'grossing up' the change in margin by some or all of the claims and expenses. The amount presented in profit or loss could be based on estimated claims and expenses determined at inception of the contract, or based on the actual claims and expenses that occurred during the reporting period. Whichever of those approaches is adopted, determining the amount presented in profit or loss could require significant costs (eg those associated with tracking historical information) and could result in amounts in profit or loss that cannot be related in a clear and understandable way to the amounts in the statement of financial position. Therefore, the Board rejected this approach.

BC166 In the Board's view, information about premiums, claims and expenses is relevant to users of financial statements. Therefore, the Board proposes to require disclosure of such information.

Premium approaches

BC167 The Board also considered premium approaches for the recognition of income and expense in profit or loss, as follows:

(a) In a 'written premium' approach, premiums received are presented as revenue when receivable and at the same time the corresponding increase in the liability is presented as an expense. Many existing accounting models apply this approach to life insurance contracts.

(b) Under an approach based on allocation of the premium (or 'earned premium'), premiums received are presented as a pre-claims obligation ('unearned premium') in the statement of financial position (ie as performance obligations). As the insurer performs under the contract by providing insurance coverage, the pre-claims liability is released and recognised in the statement of comprehensive income as premium revenue. Many existing accounting models apply this approach to non-life insurance contracts.

BC168 Supporters of premium approaches believe such approaches provide information about the amount of premiums relating to coverage provided during a period. Many users of financial statements regard such information as a key performance measure for an insurer. However:

(a) for a written premium model, the pattern of premium payments may not reflect the services provided by the insurer during the contract term. Therefore, a written premium approach would be inconsistent with existing practices for recognising and presenting revenue for contracts other than insurance contracts, and with the proposed model in the exposure draft *Revenue from Contracts with Customers.*

(b) as discussed in paragraphs BC22–BC35, allocation of the premium or a part of that premium is inherently challenging for some types of insurance contracts, (eg immediate annuities, stop-loss contracts, and contracts that contain significant guarantees and options).

(c) premium approaches do not reflect changes in the building blocks that make up the measurement of the insurance contract.

BC169 Therefore, the Board does not propose that insurers apply a premium approach for presentation, except for pre-claims liabilities of short-duration contracts that are measured using the modified approach. In the Board's view, for those contracts a presentation approach showing the allocated premium (ie the earned premium) as revenue and incurred claims as an expense would be consistent with the proposed revenue recognition model and would provide users with relevant information that faithfully represents the performance of these contracts.

Combination of a margin approach and a premium approach

BC170 The Board also considered combining a margin approach with a premium approach, by using an explicit measurement of insurance coverage to identify premiums as revenue as the insurer performs under the contract. However, a combined approach would require an insurer to apply two models: the proposed insurance contracts model for liability measurement and the proposed revenue recognition model to determine the amount recognised as revenue. The Board concluded that such an approach would be unduly costly and burdensome. Also, as referred to in paragraph BC168(b), applying an allocation of premiums based on the proposed revenue recognition model can be challenging for some types of insurance contracts.

No presentation in other comprehensive income

BC171 The draft IFRS carries forward the proposal in the discussion paper that all income and expense arising from changes in the carrying amount of an insurance contract asset or liability should be presented in profit or loss. Most respondents to the discussion paper agreed with that proposal. However, some respondents believed that the Board should require or permit insurers to present in other comprehensive income some or all income or expense, for one or both of the following reasons:

(a) to avoid accounting mismatches if assets backing insurance liabilities are not measured at fair value through profit or loss (paragraphs BC172–BC181).

(b) to distinguish short-term market volatility that might reverse over the long term of the insurance contracts from other changes in the carrying amount of the insurance contract asset or liability (paragraphs BC182 and BC183).

Accounting mismatches

BC172 The Basis for Conclusions on IFRS 4 distinguishes two types of mismatches:

(a) An 'economic mismatch' arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. For example, an economic mismatch arises if the duration of insurance liabilities is longer than the duration of fixed interest assets backing those liabilities.

(b) An 'accounting mismatch' arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because different measurement attributes are applied.

BC173 Users and preparers of financial statements and other interested parties have consistently stated that it is important for insurers to account for insurance contracts and related assets in a manner that avoids accounting mismatches. They have noted that it is burdensome for insurers to explain the effects of accounting mismatches even to sophisticated users, and less sophisticated users may be less able to understand these effects. In the discussion paper, the Board expressed the preliminary view that an ideal measurement model would report all economic mismatches and would not create any accounting mismatches.

BC174 A common cause of accounting mismatches for insurers relates to measuring interest-bearing financial assets at fair value when insurance contracts are measured on a basis that does not reflect current interest rates. If interest rates change, the carrying amount of the assets changes but the carrying amount of the insurance liabilities does not, with the following consequences:

(a) For financial assets classified as 'at fair value through profit or loss', there is an accounting mismatch in both the statement of comprehensive income and the statement of financial position.

(b) For measurements of financial assets measured at fair value in the statement of financial position but not in profit or loss (such as 'available-for-sale financial assets' under IAS 39 or equity instruments measured at fair value through other comprehensive income under IFRS 9), there is no accounting mismatch in profit or loss (unless the assets are sold), but there is an accounting mismatch in other comprehensive income and, consequently, also in equity.

(c) If the insurer sells assets, an accounting mismatch occurs not only for available-for-sale financial assets, but also for assets carried at amortised cost.

BC175 In developing the draft IFRS, the Board considered the following approaches to address accounting mismatches for insurers:

(a) changing the accounting for an insurer's assets, or

(b) requiring or permitting an insurer to present some or all changes in its insurance liabilities in other comprehensive income.

BC176 In the Board's view, it would not be appropriate to change the accounting for an insurer's assets, other than assets relating to unit-linked and index-linked insurance contracts, see paragraphs BC153–BC155, because:

(a) other assets and liabilities of an insurer are outside the scope of the draft IFRS.

(b) it would be undesirable to create industry-specific requirements for the accounting for assets. To do so would reduce transparency and perpetuate the barriers that impede communication between insurers and users of their financial statements.

(c) it may not be possible to identify which of the insurer's assets are held to back insurance liabilities and which are not.

BC177 The Board considered whether to require or permit insurers to present in other comprehensive income changes in insurance liabilities backed by assets that are not measured at fair value through profit or loss in accordance with IFRS 9. Assets not measured at fair value through profit or loss include:

(a) financial instruments that are measured at amortised cost in accordance with IFRS 9 (paragraphs BC178 and BC179).

(b) some investments in equity instruments for which IFRS 9 permits gains and losses to be presented in other comprehensive income (paragraph BC180).

Amortised cost

BC178 The Board does not propose to permit or require insurers to present in other comprehensive income changes in the carrying amount of insurance liabilities backed by financial assets that are measured at amortised cost. Such presentation:

(a) might eliminate some or all of the mismatch in profit or loss, but would not eliminate the accounting mismatch from comprehensive income or equity.

(b) would be complex and difficult to understand.

(c) would be onerous for insurers because of the need:

(i) to determine the part of the insurance liability deemed to be backed by assets measured at amortised cost.

(ii) to track 'cost' information for that part of the liability, to achieve the desired split between amounts recognised in profit or loss and amounts recognised in other comprehensive income.

(iii) to determine whether, and when, to recycle amounts from other comprehensive income to profit or loss.

BC179 Furthermore, an insurer could avoid this accounting mismatch by using the fair value option for its assets.

Other comprehensive income presentation alternative for some equity instruments

BC180 The Board does not propose to permit or require insurers to present in other comprehensive income changes in insurance liabilities backed by equity instruments measured at fair value through other comprehensive income because:

(a) an insurer's insurance liabilities may not be fully backed by those equity instruments measured at fair value. Thus, an insurer would report part of the changes in the carrying amount of its insurance liabilities in other comprehensive income and part in profit or loss. The resulting complexity would not be clear, transparent, understandable or informative for users of financial statements.

(b) the requirement would be onerous for insurers because of the need to determine the part of the insurance liability deemed to be backed by equity instruments measured at fair value through other comprehensive income.

(c) presenting changes in fair value of equity instruments in other comprehensive income is optional. Thus, no insurer is required to suffer the mismatch discussed above.

Shadow accounting

BC181 The proposal to present all income and expense from insurance contracts in profit or loss eliminates the need for a practice known as 'shadow accounting'. Shadow accounting has two forms, as follows:

(a) In some accounting models, the measurement of some or all of an insurer's non-participating insurance liabilities depends on realised gains and losses on an insurer's assets. For example, section 944-30-35* of FASB ASC Topic *Financial Services – Insurance* requires some insurance liabilities to be measured on the basis of the estimated gross profit, including amounts expected to be earned from the investment of policyholder balances. To eliminate the mismatch between assets measured at fair value through other comprehensive income and unrealised gains and losses, shadow accounting adjusts the insurance liability so that unrealised gains and losses are recognised in the same way as realised gains and losses. The proposals in the draft IFRS do not measure non-participating insurance contracts on the basis of gains and losses on assets. Thus, this application of shadow accounting would no longer be relevant.

(b) When policyholders participate wholly or partly in returns on assets measured at fair value through other comprehensive income, shadow accounting adjusts other comprehensive income to reflect that participation. This form of shadow accounting could be relevant because IFRS 9 permits some equity instruments to be measured at fair value through other comprehensive income. However, IFRS 9 requires that, for such equity instruments, entities recognise only dividend income in profit or loss, with realised and unrealised gains and losses recognised in other comprehensive income. As a consequence, shadow accounting is likely to result in complexity that would not be easy for users to understand or for preparers to apply. Therefore, the Board proposes not to retain shadow accounting (currently permitted under IFRS 4).

* originally introduced by SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

Short-term market volatility

BC182 Some respondents to the discussion paper proposed that an insurer should recognise in other comprehensive income changes in the insurance liability arising from changes in financial inputs or market variables. Those respondents believe this approach:

(a) would represent the economics of the insurance business more faithfully than recognising all changes in the carrying amount of the insurance liability in profit or loss because it would distinguish the insurer's longer-term performance from changes they regard as short-term.

(b) permit insurers to present performance on a basis comparable to financial institutions, such as banks, that use amortised cost for some of their financial assets and many of their financial liabilities.

(c) would be consistent with the proposals in the exposure draft *Defined Benefit Plans*, which proposes the use of other comprehensive income to report remeasurements of post-employment benefit liabilities. Some respondents to the discussion paper viewed post-employment benefit liabilities and insurance liabilities, particularly some long-duration life insurance contracts, as having some common characteristics.

BC183 In the Board's view, gains and losses on insurance contracts are a core part of an insurer's performance in both the short term and long term. Therefore, presentation of those gains and losses in profit or loss is appropriate. The Board welcomes comments on how gains and losses from insurance liabilities can be presented in profit or loss in a way that best depicts their relationship with gains and losses from the assets backing those liabilities.

Assets underlying unit-linked contracts (paragraphs 71 and 78)

BC184 Unit-linked contracts are contracts for which some or all of the benefits are determined by reference to the price of units in an internal or external investment fund (ie a specified pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund, sometimes also referred to as 'separate account' in the context of US GAAP).

BC185 For unit-linked contracts, all of the investment performance of the underlying pool of assets is passed to the holders of the contracts. As a result, the shareholders and other policyholders neither benefit nor suffer from that investment performance (except through guarantees of minimum returns in specified circumstances, for example on death or maturity). In contrast, for more 'traditional' types of insurance contracts, actual investment returns do not determine the benefits paid to policyholders.

BC186 In the Board's view, presenting the assets backing unit-linked contracts separately from the insurer's other assets would provide useful information to users of financial statements because those assets do not expose the insurer to the same risks as other assets. Therefore, the Board proposes that for unit-linked contracts an insurer should:

(a) present the pool of assets underlying unit-linked contracts separately from the insurer's other assets. This implies that any interest the insurer holds in the underlying fund for its own account should be presented together with other assets.

(b) the portion of the liabilities from unit-linked contracts linked to the pool of assets in (a) separately from the insurer's other insurance contract liabilities.

BC187 Similarly, the Board proposes that insurers should present single line items for both income and expense from the pool of assets underlying unit-linked contracts and from the portion of the liabilities linked to those assets, separately from income and expense from the insurers' other assets and insurance contract liabilities. Such presentation would reflect the nature of these contracts in a transparent way and provide users of financial statements with information about the insurer's performance on unit-linked contracts. It would also distinguish those investment returns that affect the insurer directly from those investment returns that are contractually passed through to policyholders.

Scope (paragraphs 2–7)

BC188 The Board proposes that the IFRS should apply to insurance contracts and to financial instruments that contain a discretionary participation feature. The draft IFRS does not deal with other assets and liabilities of insurers, nor does it deal with accounting for insurance contracts by policyholders (other than by cedants).

Definition of an insurance contract (Appendix A)

BC189 The draft IFRS proposes that the accounting model would apply to all types of insurance contract: life and non-life, direct insurance and reinsurance. The accounting model would apply throughout the life of a contract, in both:

(a) the pre-claims period (the coverage period when the insurer is standing ready to meet valid claims),* and

(b) the claims handling period (when the insured events have occurred but the ultimate payment is uncertain). For some non-life insurance contracts, the claims handling period can extend for many years. For life insurance, the pre-claims period extends throughout the coverage period, but the claims handling period is generally very short because there is little or no uncertainty about the payment once the insured event has occurred, and payment generally occurs quickly.

BC190 The definition of an insurance contract proposed in the draft IFRS is based on the definition in IFRS 4 (including the related guidance in Appendix B of IFRS 4). In the discussion paper, the Board did not propose a new definition of insurance contract, but proposed to consider whether the definition in IFRS 4 was still appropriate when it developed the draft IFRS, together with considering input from the FASB's project on insurance risk transfer.

BC191 In developing the draft IFRS, the Board compared the IFRS 4 definition with US GAAP requirements to identify possible improvements that could be made to that definition and considered the main differences, as follows:

(a) *use of 'compensation' rather than 'indemnification' in describing the insurance contract benefit.* In the Board's view, these terms have broadly the same meaning. However, describing an insurance contract as compensating the policyholder may be more intuitive in some instances, for example in referring to a death benefit in a life insurance contract that compensates the beneficiary with a specified amount for the loss of the insured's life. Accordingly, the Board retained 'compensation' in the definition of an insurance contract.

* A modified version of the model would apply to the pre-claims period of short-duration contracts, as discussed in paragraphs BC145–BC148.

(b) *the role of timing risk*. US GAAP requires the presence of both timing risk and underwriting risk in an insurance contract, whereas IFRS 4 treats contracts that transfer either underwriting risk or timing risk as insurance contracts. In US GAAP, much of the pressure on the notions of underwriting risk and timing risk arises because the accounting for some insurance contracts does not require insurers to discount the expected future cash flows when measuring the insurance liability. However, that pressure is not present in the model proposed in the draft IFRS. Therefore, the Board does not propose to require the presence of both timing risk and underwriting risk. However, the draft IFRS introduces a proposal that an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario (ie if an insured event occurs) are significant (see paragraph B26).

(c) *the notion of a loss.* When an insurer assesses whether an insurance contract transfers significant insurance risk, IFRS 4 requires the insurer to consider whether an insured event could require significant additional benefits in any scenario that has commercial substance (see paragraph B23 of IFRS 4 and paragraph B24 of the draft IFRS). The Board understands that practice under US GAAP considers whether the present value of net cash outflows can exceed the present value of premiums in any scenario. The Board proposes to import that as an additional test (see paragraph B25 of the draft IFRS). Although the Board has no specific reason to think that the absence of such a test in IFRS 4 has led to misleading classification of contracts, the inclusion of such a test is consistent with the Board's understanding of practice under US GAAP.

BC192 Paragraphs BC11–BC60 of the Basis for Conclusions on IFRS 4 discuss other aspects of IFRS 4's definition of an insurance contract.

Coverage against credit defaults

BC193 IFRSs define a financial guarantee contract as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. These contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract, but their accounting treatment does not depend on their legal form. In phase I of this project, the temporary solution in IFRS 4:

(a) permits insurers to treat these contracts as insurance contracts.

(b) requires other entities to treat them as financial instruments, measured initially at fair value (typically equal to the consideration received), with subsequent amortisation of that amount, coupled with a test for credit losses.

BC194 These contracts transfer credit risk. Some view all contracts that transfer credit risk as financial instruments. However, a contractual precondition for a payment under the contracts described in the previous paragraph is that the holder has suffered a loss—a distinguishing feature of insurance contracts. Therefore, the Board proposes that the definition of an insurance contract should continue to capture these contracts and that they should be within the scope of the draft IFRS. In the Board's view, the proposed accounting model for insurance contracts is equally appropriate for this particular subset of insurance contracts.

BC195 Because contracts meeting the Board's existing definition of a financial guarantee contract also meet the definition of an insurance contract (unless the transfer of insurance risk is insignificant), the proposal to use the proposed insurance contracts model for all those contracts removes the need for the definition of a financial guarantee contract. Thus, it would be withdrawn.

BC196 For some credit-related contracts, it is not a precondition for payment that the holder has suffered a loss. An example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index. Those contracts are derivatives and do not meet the definition of an insurance contract. The issuer would continue to account for them as derivatives.

BC197 Although US GAAP requires issuers of most guarantees to recognise them at fair value, that requirement does not apply to guarantees issued between parents and their subsidiaries, between entities under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent. In 2005 the Board decided not to introduce such an exemption in IFRSs and it does not propose one now. The Board believes that failing to account for liabilities under such guarantees would not provide a faithful representation of the issuer's financial position.

Financial instruments with discretionary participation features (paragraph 2(b))

BC198 The Board proposes that issuers of financial instruments with discretionary participation features ('participating investment contracts') should apply the draft IFRS to those contracts. Although those contracts do not meet the proposed definition of an insurance contract, the Board noted the following advantages of treating participating investment contracts in the same way as participating insurance contracts, rather than as financial instruments:

(a) Participating investment contracts and participating insurance contracts are sometimes linked to the same underlying pool of assets (and sometimes participating investment contracts even share in the performance of insurance contracts). Using the same approach for both types of contract will produce more relevant information for users and simplifies the accounting for those contracts. For example, some cash flow distributions to participating policyholders are made in aggregate for both participating insurance and investment contracts, making it problematic to apply different accounting models to different parts of that aggregate participation.

(b) Both of these types of contracts often have characteristics, such as long maturities, recurring premiums and high acquisition costs, that are more commonly found in insurance contracts than in most other financial instruments. The proposed model for insurance contracts was developed with the specific aim of generating useful information about contracts containing these features.

(c) Participating investment contracts contain a complex package of interdependent options and guarantees (eg minimum guarantees, surrender options, conversion options and paid-up options). Accordingly, some of these features might be separated into components under the Board's current and proposed requirements for financial liabilities. Splitting these contracts into components with different accounting treatments would not be a faithful representation of the package as a whole, resulting in information that is not understandable, and would be burdensome and costly.

BC199 The FASB concluded that these arguments are insufficient to justify excluding these contracts from the scope of its financial instruments standards (see the Appendix).

BC200 In contrast, the Board found the arguments listed in paragraph BC198 persuasive and proposes to apply the draft IFRS to those contracts.

BC201 To identify the participating investment contracts that should be within the scope of the draft IFRS, the Board proposes to use the existing definition of a discretionary participation feature (DPF) in IFRS 4, with one modification to reflect a factor that the Board found particularly persuasive. The amendment would stipulate that the contracts must share in the performance of the same pool of assets as do participating insurance contracts. The Board is not aware of any reason to make any other changes to the definition of a DPF.

BC202 The definition of a DPF plays a less significant function in the draft IFRS than in IFRS 4. In IFRS 4, the definition applies to both participating insurance contracts and participating investment contracts, and it serves to permit specified practices to continue until the Board replaces IFRS 4. In contrast, the only function of the definition of a DPF in the draft IFRS is to define which participating investment contracts are within the scope of the accounting model that is proposed for insurance contracts.

BC203 In addition, because participating investment contracts do not transfer significant insurance risk, the draft IFRS proposes the following modifications to the proposals for insurance contracts (paragraphs 64 and 65):

(a) The contract boundary principle for these contracts builds on the defining characteristic of these contracts, namely the presence of the discretionary participation features, rather than the existence of insurance risk.

(b) The proposed requirement for the release of the residual margin refers to the pattern of provision of asset management services, rather than the pattern of claims and benefits.

Scope exclusions (paragraph 4)

BC204 The draft IFRS proposes to carry forward the following scope exclusions based on IFRS 4:

(a) product warranties issued by a manufacturer, dealer or retailer (see paragraphs BC207 and BC208).

(b) employers' assets and liabilities under employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans (see IAS 19 *Employee Benefits*, IFRS 2 *Share-based Payment* and IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).

(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (see IAS 17 *Leases*, IAS 18 and IAS 38 *Intangible Assets*).

(d) residual value guarantees provided by a manufacturer, dealer or retailer or embedded in a lease (see the exposure draft *Revenue from Contracts with Customers* and the forthcoming exposure draft *Leases*). However, stand-alone residual value guarantees are not addressed by the Board's other projects and would remain within the scope of the insurance IFRS.

(e) fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event (see paragraphs BC209 and BC210).

(f) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).

(g) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder).

BC205 In addition, the draft IFRS does not address accounting for insurance contracts by policyholders. The Board believes that there are no pressing reasons to address this topic now. Although no specific standard addresses policyholder accounting comprehensively, some IFRSs address limited aspects of policyholder accounting. These include the paragraphs in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* that specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. Accordingly, the Board has not considered policyholder accounting, except for reinsurance contracts.

Product warranties (paragraph 4(a))

BC206 The exposure draft *Revenue from Contracts with Customers* identifies two categories of product warranties:

(a) warranties issued for short coverage periods to cover any defects that were undetected during the manufacture of the product. These warranties do not meet the definition of an insurance contract because they are intended to ensure that the seller satisfied the performance obligation, rather than to provide compensation for an uncertain future event.

(b) warranties that provide coverage for the customer for faults that arise after the product is transferred to the customer. These warranties meet the definition of an insurance contract and are often issued by an unrelated third party.

BC207 IFRS 4 regards all product warranties as insurance contracts, but excludes from its scope product warranties issued by a manufacturer, dealer or retailer. Under the draft IFRS, product warranties issued by a manufacturer, dealer or retailer would continue to be outside the scope of the IFRS on insurance contracts, either because they would now be analysed as not meeting the definition of an insurance contract (warranties against undetected defects) or because they would continue to be excluded from its scope (warranties providing coverage against subsequent faults).

Fixed-fee service contracts (paragraph 4(e))

BC208 A fixed-fee service contract is a contract in which the level of service depends on an uncertain event. Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. Such contracts meet the definition of an insurance contract because:

(a) it is uncertain whether, or when, a repair or assistance is needed;

(b) the owner is adversely affected by the occurrence; and

(c) the service provider compensates the owner if a repair or assistance is needed.

BC209 The Board proposes to exclude fixed-fee service contracts from the scope of the proposed IFRS if their primary purpose is the provision of services. In the Board's view, the existing practice of accounting for such contracts as revenue contracts provides relevant information for the users of financial statements for the entities that issue such contracts and changing the existing accounting for these contracts would impose costs and disruption for no significant benefit.

Identifying the insurance contract (unbundling) (paragraphs 8–11)

BC210 As discussed in paragraph BC14, insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows and cash outflows. In addition, paragraph BC15 explains that some insurance contracts provide more than just insurance coverage.

Insurance contracts can, for example, also provide the policyholder with goods or services other than insurance coverage (a revenue-generating transaction with a customer) or an investment (a financial instrument). Such components would, if accounted for as if they were separate contracts (unbundling), be within the scope of another IFRS. Goods or services other than insurance coverage would be accounted for under the revenue model and investment components would be accounted for under IFRS 9 or IAS 39.

BC211 The discussion paper proposed unbundling in some cases but not all, considering the extent to which interdependency would allow the insurer to measure a component separately. For conceptual and practical reasons, some respondents agreed with unbundling when it could be done in a way that is not arbitrary. Others opposed unbundling in all cases.

BC212 The Board identified the following benefits of unbundling an insurance contract:

(a) Transparency—unbundling can provide insight into the components of an insurance contract that do not respond to changes in circumstances in the same manner as components affected by insurance risk.

(b) Comparability—unbundling means that an insurer accounts in the same way for a non-insurance component as another entity with a separate, but otherwise identical, contract (eg a financial instrument issued by a bank or a fund manager). This would avoid sharp accounting discontinuities. Because unbundling would result in similar accounting for similar contracts, users of financial statements can better understand the risks undertaken by an entity, regardless of the type of business or industry in which the entity operates.

BC213 However, the Board also noted limitations of unbundling. Separating a single contract into components when the cash flows attributable to the components are intertwined could result in complex accounting. For example, it would require separating the intertwined cash flows, measuring them using a different measurement to comply with the accounting requirements, and tracking those separate cash flows throughout the life of the contract. Furthermore, in some cases an insurer may not be able to identify evidence to decide what to allocate to each of the components (in other words; separating the components goes beyond requiring the insurer's judgement and becomes arbitrary).

BC214 In developing the draft IFRS, the Board considered whether to require (or permit) unbundling, and, if so, which components should be unbundled. Requiring unbundling in all cases is unlikely to be appropriate because there are instances in which unbundling could diminish the usefulness of the financial statements if interdependent cash flows were arbitrarily split and measured on different bases. However, the Board concluded that in instances where a component is not closely related to the insurance coverage specified in the contract, unbundling that component would produce useful information at a reasonable cost.

BC215 An approach to unbundling that considers whether a component is closely related would provide a natural link with existing requirements for bifurcation. However, the Board's intention is not to require an exhaustive search for components in every insurance contract. Rather, the point of unbundling those components is to assist users in understanding the different facets of a hybrid contract, while achieving some degree of comparability between entities across industries.

BC216 To clarify its intention and assist insurers in applying the unbundling requirements, the Board identified the following most common examples of components that are not closely related to the insurance coverage:

(a) an investment component reflecting an account balance that meets criteria specified in paragraph 8(a) of the draft IFRS. As a result of those criteria, all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, belong to either the insurance component or another component, but are not part of the investment component. Thus, the crediting rate applied to that account balance is determined after eliminating any cross-subsidy between that rate and the charges or fees assessed against the account balance. In that way, the investment component (account balance) would behave in a way similar to a stand-alone investment contract, without being affected by any cross-subsidy.

(b) an embedded derivative that is separated from its host contract in accordance with IAS 39. Paragraphs BC220–BC225 discuss embedded derivatives.

(c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

BC217 Other approaches to unbundling considered by the Board were based on:

(a) whether the component is so interdependent that the components cannot be measured separately on a basis that is not arbitrary (this was Board's preliminary view in the discussion paper).

(b) whether the component can introduce variability in the overall cash flows of the insurance contract for risks that are not considered part of the provision of insurance protection.

BC218 The Board rejected these approaches because of their potential lack of clarity; using either of those approaches would introduce a new bifurcation notion and might require extensive and detailed guidance.

BC219 The Board considered whether to permit unbundling when it is not required (ie when components are closely related). Some argue that, even though insurers are unlikely to opt for unbundling, they should be permitted to do so. Some insurers might find it easier to account for some components embedded in insurance contracts using the relevant guidance for similar stand-alone contracts. However, the Board concluded that permitting unbundling when it is not required would be inconsistent with the reasoning for not requiring it in the first place; it does not seem rational to permit something that would not be decision-useful. It could also undermine comparability.

Embedded derivatives (paragraph 12)

BC220 The Board identified an embedded derivative that is bifurcated under IAS 39 as a common example of a component that is not closely related to the insurance coverage. (Paragraphs BC76–BC82 discuss some of the embedded derivatives commonly found in insurance contracts.)

BC221 The existing bifurcation guidance in paragraphs AG30–AG33 of IAS 39 requires bifurcation of an embedded derivative if its economic characteristics and risks are not closely related to the host contract. More specifically, paragraph AG33(h) explains that an embedded derivative in an insurance contract is closely related to the economic characteristics and risks of the host insurance contract if that derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately, ie without considering the host contract.

BC222 The Board concluded that applying this existing bifurcation guidance would be internally consistent with the overall basis for unbundling, which also considers whether a component is closely related (see paragraph BC216). The Board did not address the bifurcation guidance in IAS 39 in its project on insurance contracts.

BC223 Some embedded derivatives meet the definition of an insurance contract. Those derivatives are not within the scope of IAS 39; an insurer applies IFRS 4 to such derivatives. The Board does not intend to change this; if an embedded derivative meets the definition of an insurance contract, that embedded derivative will be within the scope of the draft IFRS, and will not be bifurcated.

BC224 One example of an embedded derivative included in an insurance contract is a surrender option. Surrendering an insurance contract generally leads to cancellation of the entire contract (which would include any embedded derivatives and account balances). Therefore, a surrender option is often interdependent with various components of the contract and it may be difficult and burdensome to separate the effects of the surrender option. Applying paragraph AG33(h) of IAS 39, an insurer would determine whether that surrender option is closely related to the host insurance contract.

BC225 Paragraph 8 of IFRS 4 specifies that, as an exception to IAS 39, an insurer need not bifurcate a policyholder's option to surrender an insurance contract for a fixed amount, even if the exercise price differs from the carrying amount of the host insurance contract. Paragraph 9 of IFRS 4 provides the same exception for financial instruments that contain a discretionary participation feature. Because paragraph AG33(h) of IAS 39 already provides bifurcation guidance consistent with the proposed overall approach to unbundling, the draft IFRS does not carry forward this exception as a separate item. Instead, an insurer would apply the requirements in IAS 39 to determine whether it needs to bifurcate a surrender option.

Recognition (paragraphs 13–15) and derecognition (paragraphs 67 and 68)

BC226 The discussion paper proposed that an insurer should recognise an insurance contract when it becomes a party to the contract and the draft IFRS contains a similar proposal. This is consistent with the principle for recognising financial assets and financial liabilities in other IFRSs. Respondents to the discussion paper generally agreed with that proposal.

However, some respondents asked the Board to clarify how to account for insurance contracts entered into a significant time (eg a few months) before the start of the coverage period. They questioned whether insurers should instead treat such contracts before the start of the coverage period as derivatives or as fully executory. However, the Board concluded that:

(a) no benefit would arise for users if an insurer were to account separately for an insurance contract as a derivative (an option or forward) before the start of the coverage period. A derivative contract to provide insurance in the future would meet the definition of an insurance contract and be measured in the same way as the underlying insurance contract. Therefore, accounting for an insurance contract as a derivative before it starts would add complexity without providing any improved information for users.

(b) an insurer should not treat an insurance contract in the same way as an executory contract before the start of the coverage period. Typically, entities do not recognise assets and liabilities as a result of executory contracts. Although in most cases there would be no significant assets and liabilities between signing the contract and the start of the coverage period, recognising the contract in the financial statements at the date it is signed would require the insurer to account for changes in circumstances that make the contract onerous.

BC227 The draft IFRS proposes that an insurance contract liability should be derecognised when it has been extinguished. This proposal is consistent with the proposal in the discussion paper that insurance liabilities should be derecognised on the same basis as financial liabilities, is consistent with the requirement in IFRS 4 and provides symmetrical treatment for the recognition and derecognition of insurance contracts.

BC228 Some respondents to the discussion paper said that an insurer might not know precisely whether a liability has been extinguished because claims are sometimes reported many years after the end of the coverage period. Those respondents were concerned that an insurer might be unable to derecognise those contracts, which in some cases might result in accounting that is unreasonable and unduly burdensome. However, in the Board's view, it would not be a faithful representation of an insurer's financial position to ignore contractual obligations that remain in existence and can generate valid claims. Also, an insurer would not measure the liability at a material amount if it has no information that a possible claim exists. Accordingly, there may be little practical difference between recognising an insurance liability measured at an immaterial amount and derecognising the liability.

BC229 Because derecognition of financial assets is a complex topic and the subject of another project, the draft IFRS does not address derecognition of insurance assets.

Reinsurance (paragraphs 43–46)

BC230 This section deals with reinsurance liabilities of a reinsurer and reinsurance assets of a cedant (ie the insurer holding a reinsurance contract).

Reinsurance liabilities of a reinsurer

BC231 The Board has identified no reason to apply different requirements to direct insurance liabilities and reinsurance liabilities. Therefore, the draft IFRS proposes that a reinsurer should use for the reinsurance contracts that it issues the same recognition and measurement approach as all insurers use for the other insurance contracts that they have issued.

Reinsurance assets of a cedant (paragraphs 43–46)

BC232 The draft IFRS carries forward the following requirements of IFRS 4, because the Board is aware of no reason to change them:

(a) An insurer does not derecognise insurance liabilities until the contractual obligations are extinguished (by discharge, cancellation or expiry). It follows that a cedant typically would not derecognise the related direct insurance liabilities upon entering into a reinsurance contract.

(b) A cedant does not offset reinsurance assets against related insurance liabilities, and does not offset reinsurance income and expense against related insurance expense and income.

BC233 The draft IFRS proposes that a cedant should measure its reinsurance assets on the same basis as its underlying direct insurance liability. The following paragraphs discuss two aspects of reinsurance assets:

(a) margins (paragraphs BC234–BC237).

(b) impairment (paragraphs BC238–BC241).

Margins

BC234 The amount paid for reinsurance by a cedant comprises premiums paid by the cedant, less ceding commissions paid by the reinsurer, and can be viewed as payment for the following:

(a) the reinsurer's share of the expected present value of the cash flows generated by the underlying direct insurance contract(s).

(b) a risk adjustment for the risk associated with the underlying direct insurance contract(s). For those underlying contracts, the risk adjustment increases the measurement of the cedant's liability. In contrast, the risk adjustment increases the measurement of the cedant's reinsurance asset. This is because the reinsurance asset reduces risk for the cedant. The greater the risk arising from the underlying insurance contracts, the greater the value to the cedant of its reinsurance asset.

(c) an adjustment for the risk of non-performance by the reinsurer (ie the risk that the reinsurer may dispute coverage or fail to satisfy its obligations under the reinsurance contract).

(d) a residual margin that makes the initial measurement of the reinsurance asset equal to the premium paid at inception. This margin may differ from the residual margin arising for the underlying direct insurance contract(s).

BC235 Although both the cedant and reinsurer would measure their contractual rights and obligations on the same basis, in practice they would not necessarily arrive at the same amount (ie there is no 'mirror accounting'). This may be because the estimates are based on access to different information and different experiences as well as differences in the composition of their portfolios, for example by including different adjustments for diversification effects.

BC236 The amount paid by the cedant would typically exceed the expected present value of cash flows generated by the reinsurance contracts plus the risk adjustment. Thus, a positive residual margin would typically arise at the initial recognition of a reinsurance contract. The Board considered whether the residual margin in the reinsurance contract could be negative if, in rare cases, the amount paid by the cedant is less than the expected present value of cash flows plus the risk adjustment. The Board noted that the most likely causes of such a negative difference would be:

(a) an overstatement of the underlying direct insurance contract(s). A cedant would deal with this by reviewing the measurement of the direct contract(s).

(b) favourable pricing by the reinsurer, for example as a result of diversification benefits. The Board concluded that the recognition of a gain would be appropriate in such cases. This is because doing so is consistent with the Board's conclusion that the residual margin for the underlying contract should not be negative (although for the underlying contract the consequence is the immediate recognition of a loss, rather than the immediate recognition of a gain).

BC237 National accounting requirements have often tried to address a concern that profit or loss might be distorted by the timing of the decision to buy reinsurance. Such distortions are a particular concern if contracts have the legal form of reinsurance but do not transfer significant insurance risk (sometimes known as financial reinsurance). Such distortions arise because of inadequacies in some existing measurement approaches for the underlying insurance liabilities, for example, the use of an undiscounted measurement basis for many non-life insurance claims liabilities. By eliminating those inadequacies in the measurement of the underlying contract(s), the proposals in the draft IFRS would significantly reduce the need for restrictions on the recognition of misleading gains at initial recognition of reinsurance contracts.

Impairment

BC238 A cedant faces the risk that the reinsurer may default, or may dispute whether a valid claim exists for an insured event. There are two possible approaches to account for this risk:

(a) incurred loss model: losses should be recognised only when an event, occurring after initial recognition of an asset, provides objective evidence that the asset is impaired.

(b) expected loss model: losses should be recognised for expected (probability-weighted) losses from default or disputes.

BC239 IAS 39 determines the impairment of financial assets by applying an incurred loss model. Proponents of an incurred loss model believe that it provides more objectivity than an expected loss model. In developing IFRS 4, the Board adopted an incurred loss model for reinsurance assets because its aim was to achieve consistency with IAS 39 in a context where many reinsurance assets were not measured at a current value.

BC240 However, because the proposed measurement model uses an expected value approach for the underlying cash flows, the Board now proposes to require an expected loss model for reinsurance assets. In other words, the current exit value of the reinsurance asset would incorporate a reduction for the expected (probability-weighted) present value of losses from default or disputes. This is consistent with a measurement model that starts with the expected present value of cash flows. Furthermore, this approach is consistent with the Board's exposure draft *Financial Instruments: Amortised Cost and Impairment*, which proposes to switch to an expected loss model for financial assets.

BC241 The proposed expected loss model does not include a further reduction in the carrying amount of the reinsurance asset to reflect the risk that losses from defaults or disputes may ultimately exceed their expected value (in addition to the reduction for expected losses). Such a risk adjustment might be conceptually consistent with the risk adjustment proposed in the draft IFRS, but in the Board's view it would introduce excessive complexity for little or no benefit to users of a cedant's financial statements.

Disclosure (paragraphs 79–97)

BC242 The Board proposes as an objective that an insurer should disclose information to help users of financial statements understand the amount, timing and uncertainty of future cash flows, supplemented with some specific disclosures intended to help the insurer satisfy that principle. By specifying an objective, the Board eliminates the need for detailed and prescriptive disclosure requirements to meet the specific information needs for the various types of insurance contract. However, in situations when the information provided in accordance with the specific disclosures is not sufficient to meet that objective, the draft IFRS would require the insurer to disclose whatever additional information is necessary to meet that objective.

BC243 The Board used the disclosure requirements in IFRS 4 (including the disclosure requirements in IFRS 7 that are incorporated in IFRS 4 by cross-reference) as a basis for its proposals. In addition, the Board proposes to include the following items in the draft IFRS:

(a) a principle on the level of aggregation (see paragraph 79). This is consistent with other current proposals by the Board and would require an insurer to choose the most useful disaggregation level to satisfy the disclosure principle.

(b) information about the amounts recognised:

(i) a more detailed reconciliation of changes in the contract balances, including disclosures about changes in the risk adjustment, which is a key component of the measurement model (see paragraph 85).

(ii) a more detailed explanation of methods, inputs and processes used in the measurement. Because the proposed measurement for insurance contracts is a current measure of items that may be difficult to measure, the transparency of the inputs and methods used is important to users of the financial statements (see paragraph 90(a)).

(iii) a translation of risk adjustments into a confidence level for disclosure, even if the insurer had not used that technique to determine the risk adjustment (ie if the insurer used a conditional tail expectation or a cost of capital technique). That disclosure would enhance comparability among insurers (see paragraphs 90(b), BC116 and BC117).

(iv) a measurement uncertainty analysis. This would inform users about the extent to which the insurer might reasonably have arrived at different measurements (see paragraph 90(d)).

(c) information about the nature and extent of risks arising from insurance contracts: the effect of the regulatory framework in which the insurer operates. The Board recently proposed a similar requirement for post-employment benefits in the exposure draft *Defined Benefit Plans* (see paragraph 92).

Transition (paragraphs 98–102)

BC244 This section discusses:

(a) determination of the residual margin on transition (paragraphs BC245–BC249).

(b) elimination of deferred acquisition costs and some other intangibles (paragraph BC250).

(c) disclosure of claims development (paragraph BC251).

(d) first-time adopters of IFRSs (paragraph BC252).

(e) redesignation of financial assets (paragraph BC253).

Transition for a residual margin (paragraph 100(a))

BC245 As already noted, the proposed measurement model comprises two elements:

(a) a direct measurement, based on estimates of future cash flows and an explicit risk adjustment; and

(b) a residual margin, determined at initial recognition of the insurance contract and then released over the coverage period.

BC246 The Board has identified no specific transitional problems for the introduction of the direct measurement component of the measurement. That measurement is current and reflects circumstances at the measurement date. Therefore, provided an insurer has sufficient lead time to set up the necessary systems, performing that direct measurement on transition to the new model will be no more difficult than performing that measurement for a later date.

BC247 Determining the remaining amount of the residual margin on transition to the new model may be more problematic. In principle, the insurer would need to estimate the future cash flows as it would have estimated them at initial recognition of the contracts. That exercise may be burdensome and costly and is subject to bias through the use of hindsight.

BC248 IAS 8 *Accounting Policies, Changes in Estimates and Errors* prohibits the retrospective application of an accounting policy to the extent that this would be impracticable, as defined in IAS 8. The Board concluded that retrospective determination of the residual margin would sometimes be impracticable in that sense and, if not impracticable, it would often cause costs disproportionate to the resulting benefit for users. Accordingly, the exposure draft proposes that an insurer should, on first applying the new IFRS, measure its existing contracts at that date by setting the residual margin equal to zero. In consequence, for contracts in force when the new IFRS comes into effect, an insurer will not recognise residual margins as income for any subsequent period. However, the insurer will recognise income arising from the release of residual margins for contracts recognised initially after adopting the IFRS.

BC249 The Board also considered another approach that would have determined the residual margin on transition to the new IFRS as the difference (but not less than zero) between (a) the carrying amount of the insurance liability immediately before transition and (b) the present value of the fulfilment cash flows at that date. That approach would have had the

advantage of maintaining some continuity with previously reported profit or loss, without imposing significant additional costs. However, the Board rejected that approach because the resulting residual margins would not have been comparable with residual margins for subsequent contracts and would have depended significantly on the pattern of income recognition under previous accounting models, which are not uniform.

Elimination of deferred acquisition costs and some other intangibles (paragraph 100(b) and (c))

BC250 When an insurer applies the new measurement model, it would need not only to adjust the measurement of its insurance contracts, but also to eliminate some related items, if any, such as deferred acquisition costs and some intangible assets relating solely to existing contracts. Those items could be viewed as corrections for a previous overstatement of the insurance liability, and so their elimination is likely to coincide with a reduction in the measurement of the insurance liability.

Disclosure of claims development (paragraph 101)

BC251 Paragraph 44 of IFRS 4 exempts an insurer from disclosing some information about claims development in prior periods. The Board proposes to carry forward a similar exemption, for cost-benefit reasons.

First-time adopters of IFRSs (paragraph 98)

BC252 The proposed transition requirements would apply both to first-time adopters of IFRSs and to insurers that already apply IFRSs. The Board sees no reason to treat first-time adopters differently in this respect.

Redesignation of financial assets (paragraph 102)

BC253 On transition to IFRS 4, the Board permitted an insurer to redesignate its financial assets as available for sale to avoid an accounting mismatch that arises when the insurer's financial assets are measured at fair value and its insurance liabilities are measured on a cost basis (which IFRS 4 allows). The Board understands that insurers applying IFRS 9 (which removes the available for sale classification) before the new IFRS on insurance contracts may wish to reclassify some of their financial assets, where allowed, at amortised cost rather than at fair value through profit or loss in order to continue to avoid the accounting mismatch. However, because the draft IFRS would measure insurance liabilities at a current value with all

remeasurements recognised in profit or loss, accounting mismatches would arise if an insurer continues to measure its financial assets at amortised cost. To avoid that outcome, the Board proposes that on adoption of the draft IFRS an insurer would be permitted to use the fair value option to redesignate its financial assets by measuring them at fair value through profit or loss (see paragraph 100).

Effective date and early adoption (paragraph 99)

BC254 The Board will consider collectively the effective dates and transition for the IFRSs—including insurance contracts—that it has targeted to issue in 2011 and, as part of that consideration, will publish, in conjunction with the FASB, a separate consultation paper to seek comments from interested parties. Hence, the Board may modify its previously stated preferences in the case of some individual IFRSs.

BC255 Consequently, the proposed requirements do not specify a possible effective date or whether the proposed requirements could be adopted early, but the Board intends to provide enough time to implement the proposed changes.

BC256 As part of that consideration, the Board will also consider whether to permit early adoption of those IFRSs. However, because IFRS 4 permits an insurer to change accounting policies for insurance contracts if the insurer shows that the change results in more relevant or reliable information, it is unlikely to be feasible for the IASB to prohibit early adoption of the IFRS on insurance contracts.

BC257 As noted in the Basis for Conclusions on IFRS 9 *Financial Instruments,* issued in November 2009, the Board will consider delaying the effective date of IFRS 9 if the new IFRS on insurance contracts has a mandatory effective date later than 2013, so that an insurer would not have to face two rounds of major changes in a short period.

Benefits and costs

BC258 The objective of financial statements is to provide information about an entity's financial position, financial performance and cash flows that is useful to a wide range of users in making economic decisions. To attain that objective, the Board tries to ensure that a proposed standard will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Existing investors primarily bear the costs of implementing a new standard. Although those costs

might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital, including credit, and the efficient allocation of resources in the economy.

BC259 The evaluation of costs and benefits is necessarily subjective. In making that judgement, the Board considers the following:

(a) the costs incurred by preparers of financial statements;

(b) the costs incurred by users of financial statements when information is not available;

(c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information; and

(d) the benefit of better economic decision-making as a result of improved financial reporting.

BC260 The Board thinks that the proposed IFRS would improve financial reporting by insurers because it would recognise, measure and present life and non-life insurance contracts and direct insurance and reinsurance contracts on a consistent and comparable basis (with some modifications for the pre-claims period for particular short-duration contracts. The new approach should also improve the understandability of an insurer's financial statements. In contrast, because a range of insurance accounting practices can be applied under IFRS 4 (as paragraph BC5 explains), users of an insurer's financial statements may be unable to compare those financial statements with those of another insurer that writes the same insurance business. Furthermore, under IFRS 4, an insurer's financial statements could include internal inconsistencies if different recognition, measurement or presentation principles are applied to different types of insurance contracts.

BC261 The Board believes that the building blocks approach, including the separate identification of a risk adjustment, would result in a more faithful representation of an insurance contract. Because the measurement basis is a current measurement, the proposed IFRS also resolves many of the accounting mismatches that can arise at present in an insurer's financial statements. The mismatch arises when an insurer's assets are measured at a current value amount (ie fair value) but its corresponding insurance contract liabilities are not.

BC262 Some insurers might need to make systems and operational changes to comply with the requirements in the proposed IFRS. The Board thinks that the costs involved to make systems changes to collect the information required by the proposed IFRS will be incurred primarily during the transition from IFRS 4. Depending on the internal processes that an insurer uses in managing its insurance businesses, the insurer may incur additional costs on an ongoing basis to change operational processes as well. For instance, some insurers do not regularly make an explicit estimate of the future cash flows required to fulfil an insurance contract. Similarly, determining risk adjustments is an emerging practice in the insurance industry, and so only some insurers have developed the processes and systems to do this. Although an insurer will incur costs to establish and maintain the systems and processes necessary to make explicit cash flow estimates and to manage risk adjustments, the Board thinks that this will result in the provision to users of better information about an insurer's insurance contracts and it might also improve the quality of the information that internal managers use in managing their businesses.

BC263 On balance, the Board concluded that the proposed IFRS would improve the financial reporting of insurance contracts at a reasonable cost. In developing the proposed IFRS, the Board concluded that, for some short-duration insurance contracts, the cost of applying some aspects of the proposed IFRS might exceed the benefits. Consequently, for those contracts, the Board decided to require the use of the amount of unearned premium (calculated in accordance with paragraph 56) to simplify the measurement of the pre-claims liability. As paragraph BC146 explains, the Board determined that the unearned premium would be a reasonable approximation of the present value of fulfilment cash flows and the residual margin.

Appendix

Differences between the proposals in the exposure draft and the FASB's approach

In developing the exposure draft, most of the Board's discussions on the insurance contracts model were held jointly with the FASB and many of the decisions on the features of the model were made jointly with the FASB. However, some differences remain.

The main differences between the IASB and FASB models relate to:

(a) Measurement—in the FASB model, risk and uncertainty are reflected implicitly through a single composite margin rather than explicitly through a separate risk adjustment. No measurement differences arise at initial recognition of the insurance contract because both the IASB and FASB models calibrate the residual margin and composite margin (respectively) to the consideration received or receivable from the policyholder. However, differences arise after initial recognition because in the FASB model:

   (i) the composite margin would not be remeasured to reflect any increases in risk and uncertainty or to reflect any changes in the price for bearing risk and uncertainty.

   (ii) the composite margin would be amortised over the coverage period and claims handling period according to the following formula, which is intended to approximate the pattern of the decline of risk that the insurer is subject to under the contract.

      (Premium allocated to current period + current period claims and benefits)/(Total contract premium + Total claims and benefits)

   (iii) interest is not accreted on the composite margin on the grounds of simplicity and because the FASB views the margin as a deferred credit rather than as a representation of a component of an obligation.

(b) Scope—the FASB has tentatively decided not to include participating investment contracts within the scope of a new insurance contracts standard because it believes the arguments for treating them in the same way as insurance contracts in paragraph BC199 are insufficient to justify excluding these contracts from the scope of its financial instruments standards.

The following table summarises the similarities and differences between a composite margin and a risk adjustment plus a residual margin.

	IASB: Risk adjustment plus residual margin	**FASB: Composite (single) margin**
Gain possible at inception?	No	No
Loss possible at inception	Yes	Yes (but less likely, see paragraph BC115)
Risk adjustment included in determining whether a loss arises at inception, and measuring any such loss?	Yes	No
Explicit remeasurement for risk each period?	Yes	No
Does risk adjustment decline over time?	Generally, yes, but could increase, for example if a new uncertainty emerges.	N/A
Can risk adjustment increase after initial recognition?	Yes, but this is likely to be rare in practice.	N/A
Can residual or composite margin increase after initial recognition?	No	No
How is the risk adjustment released to income over time?	Explicit measurement, reflecting reduction in remaining risk.	N/A

How is residual or composite margin released to income over time?	Over the coverage period on the basis of passage of time or, if significantly different, on the basis of the pattern of claims and benefits, as expected at inception.	On the basis of reduction in exposure from both: • the provision of insurance coverage over the coverage period, and • uncertainties related to future cash flows during the claims handling period (for life contracts usually similar to the coverage period).
Is release from risk one possible driver of the residual margin or composite margin?	No. The risk adjustment accounts for risk.	Yes
What margin is included on transition?	The risk adjustment only. The residual margin would be set at zero.	The composite margin would be set equal to the risk adjustment determined in the other approach. That adjustment would not be remeasured subsequently, it would simply be released to income in the same way as any other composite margin. This is the only purpose for which a risk adjustment would be used in the composite margin approach.

Alternative views of Jan Engström and John T Smith

AV1 Mr Engström and Mr Smith voted against publication of this exposure draft, *Insurance Contracts*, because they disagree with many of the provisions in the proposed Standard used to determine the insurance liability and to recognise changes in that liability. They believe the proposal will produce inappropriate results. They believe the proposal will impede comparability because it provides an unacceptably wide variation in determining insurance liabilities and considerable latitude to manage earnings. Mr Engström and Mr Smith further find the proposed presentation inadequate to users' needs and unsuitable for companies where insurance is not the main activity.

AV2 Mr Engström and Mr Smith disagree with the dual-margin approach specified in this exposure draft. They believe it complicates results, impedes comparability and adds another layer of subjectivity to the already highly subjective estimates of future cash inflows and outflows that can span a term of fifty plus years. They believe it is not possible to objectively compute a risk adjustment or to expect any kind of comparability from an estimate representing the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. The exposure draft identifies methods for estimating the risk adjustment. However, the risk adjustment is based on each insurer's own tolerance and price for risk thereby providing considerable latitude in deciding what level of risk should be included in the risk adjustment and what price would be charged for that level of risk. Mr Engström and Mr Smith believe that without a reference to actual transactions, the risk adjustment is not the price of risk but rather a hypothetical amount that is selected arbitrarily by each insurer choosing a level and price at that level based on its own perceptions of risk. Under the proposed approach, the risk adjustment and its complement, the residual margin, can vary significantly by insurer for the same risk thereby producing significantly different results in financial statements. Indeed, at one end of the spectrum an insurer could set the quantity and price of risk to eliminate any residual margin.

AV3 Mr Engström and Mr Smith disagree with the provision in the exposure draft that the residual margin be locked in at inception for all types of changes in the estimate of the insurance liability. They believe some changes in estimates are not primarily related to changes in insurance risk and that the resulting changes in the insurance liability should be recognised as an adjustment of the residual margin and, accordingly, recognised in profit or loss over time.

AV4 Mr Engström and Mr Smith also are concerned that the interplay between the risk adjustment and residual margin will impede comparability. For example, if two insurers have insurance contracts with similar risks but arrive at different risk adjustments at inception and in the immediate subsequent period one of them changes its estimate and now arrives at the same risk adjustment as the other, their period to period results will never be the same because the change in the risk adjustment is recognised directly in profit or loss and the residual margins being locked in at inception will never be aligned.

AV5 While Mr Smith disagrees with the dual margin approach, he believes some of its disadvantages could be mitigated if changes in the risk adjustment resulting from changes in the level of risk and price of risk selected by the insurer are recognised as an adjustment of the residual margin and changes in the risk adjustment arising from changes in the risk profile of the cash flows are recognised in profit or loss.

AV6 Mr Engström and Mr Smith disagree with the provision in the exposure draft that requires any change in expectations of customers exercising options to renew insurance contracts to be recognised in profit or loss. They believe the change should be recognised as an adjustment of the residual margin. Mr Engström and Mr Smith believe that the benefit from expectations of customers exercising options to renew insurance contracts is an intangible asset that would fail current recognition requirements. They accept the inclusion of this benefit from expectations of customer behaviour in the initial measurement of the insurance contract because no gain is recognised at inception. Any net benefit from expectations of customer renewals is included in the margin.

AV7 Mr Smith believes that, economically, part of the insurance premium charged at inception is a charge for the renewal option written by the insurer and conceptually it should be separated from the contract and recognised and measured as a written option. If recorded separately, it would be priced as an option and accounted for as a liability until it was exercised or expired. Accordingly, Mr Smith believes that any net benefit from a change in expectations of customers renewing insurance contracts should not offset the insurance liability or be recognised currently. He believes it should be an adjustment of the residual margin. Mr Smith is concerned that the proposal in the exposure draft will promote structuring opportunities for changing estimates of customer renewals. Mr Smith also is concerned about the lack of comparability as in the situation in which two insurers having insurance contracts with similar risks arrive at different expectations of customer renewals at

inception. If in the immediate subsequent period one of them changes its estimate and now arrives at the same expectation of renewals as the other, their period to period results will never be the same because the adjustment is recognised directly in profit or loss and the residual margins being locked in at inception will never be aligned.

AV8 Mr Smith disagrees with the requirement in the exposure draft to recognise participation features as a part of the insurance liability. Mr Smith believes that these features do not meet the definition of a liability under the *Framework* because the insurer has discretion over the amount or timing of the payment. He believes the recognition of these features provides a basis for managing earnings because they are intent driven and he does not understand what is so unique about an insurance contract to permit recognition of an amount based on intent. Accordingly, he also disagrees that any changes in intent about the amount the insurer will pay in the future should be recognised directly in profit or loss. Mr Smith believes there is no insurance risk associated with these features. They effectively permit the insurer to reprice the insurance contract and relate more to the pricing of the insurance product, the premium being charged. Mr Smith understands there is a relationship between the amounts of participation paid and level customer renewals. Accordingly, Mr Smith would require that any change in intent about future payments relating to these features be recognised as an adjustment of the residual margin consistent with his recommendation for the recognition of changes in customer renewals as described above.

AV9 Mr Smith disagrees with the requirement in the exposure draft for unbundling non-insurance components based on whether those components are closely related to the insurance coverage specified in the contract. Whether a component is closely related to insurance is not defined except for derivatives based on the IFRS 4 amendment to IAS 39 that specifies that an embedded derivative and the host insurance contract are closely related if they are so interdependent that the entity cannot measure the embedded derivative separately. Because closely related is based on interdependence as specified in IAS 39, Mr Smith believes that concept will be applied in all situations where there is no explicit guidance. Mr Smith is concerned about the application of that approach because the Board and the FASB struggled with the concept of interdependence and rejected it because they were unable to decide how to make it operational. Mr Smith disagrees with the application of this concept because it is not operational and in particular for derivatives because it is not applied in any other situation in which a derivative is embedded in a host contract. He does not understand what is so unique

about an insurance contract to be exempted on a basis of interdependence. Mr Smith believes this approach will create structuring opportunities to avoid recognition of derivatives at fair value by embedding them into insurance contracts. In addition, Mr Smith would require a contract that permits a policyholder to obtain a derivative-based cash settlement in lieu of maintaining insurance, to be measured and accounted for at fair value.

AV10 Mr Smith disagrees with the requirement in the exposure draft to treat financial instruments with discretionary participation features as insurance contracts because they do not contain any insurance risk. As stated above he also disagrees with recognising discretionary participation features as liabilities because they don't meet the definition of a liability under the Framework. He does not understand what is so unique about a financial instrument with a participation feature to require recognition of that instrument as an insurance liability. He believes this requirement permits structuring to avoid recognition of financial instruments under the accounting standards for financial instruments. He believes the intent-based nature of the participation feature and the subjectivity in applying a risk adjustment to estimates of cash flows under this exposure draft will create an accounting arbitrage inviting deposit taking institutions or any entity to add a participation feature to a financial liability to account for that instrument under this proposed standard. Having added a participation feature to the liability, the entity could avoid separating out embedded derivatives, then add a few renewal options, estimate cash flows considering its own tolerance and price for risk at inception and then subsequently change its intent about the extent of participation payments and immediately recognise the change in profit or loss.

AV11 Mr Engström and Mr Smith are concerned the exposure draft defines insurance contracts too broadly. Mr Smith disagrees with the requirement in paragraph B33 that specifies that a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished. He would exclude from the definition those contracts in which the insurance component has expired. He believes that any remaining obligation is a financial instrument that should be accounted for under IAS 39 or IFRS 9. He also would exclude from the definition of an insurance contract those contracts that are regarded as transferring significant insurance risk at inception only because they include a pricing option permitting the holder to purchase insurance at a specified price at a later date.

AV12 Given all of the concerns specified above, Mr Engström and Mr Smith believe the scope of this standard should be narrow and they would apply it only to life and health insurance contracts. For other insurance contracts they would favour the use of a method similar to the modified method for short-term contracts described in paragraphs 55–60.

AV13 Insurance can be described as being paid to assume risk, reimburse insurance claims, have some internal expenses and possibly earn a financial return between the payments of premiums and claims. Presentation should, in Mr Engström's and Mr Smith's opinion, follow that structure and should, regardless of performance measurement model, allow focus on revenue earned from paid premiums and actual insurance claims costs.

