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STAFF PAPER

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Project	Insurance Contracts		
Paper topic	**Review draft or re-expose**		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. This paper seeks the IASB's view on whether the proposals in its insurance contracts project can be finalised or whether the IASB should re-expose the revised insurance contracts standard.

2. This paper is accompanied by agenda paper 16E *Due Process Summary for the Insurance Contracts project* which summarises the steps the IASB has taken in developing phase II of its project to develop an insurance contracts standard. That paper demonstrates that the IASB has, for the insurance contracts project, met the requirements of all the mandatory and 'comply or explain' due process steps set out in the IASB Due Process Handbook, subject to deciding whether re-expsoure is required.

3. In addition, the cover note for the joint meeting, Agenda paper 2 *Cover note: Background information and progress report*, provides an overview of all the Board's decisions to date and a high level overview of the project and a summary of differences with the FASB.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For mo information visit www.ifrs.org

4. This paper is organized as follows:

   (a) Background and context for the IASB's insurance contracts project (paragraphs 5-8)

   (b) The IASB's procedures for re-exposure (paragraphs 9 and 10)

   (c) Revisions to the Exposure Draft (paragraphs 16–37)

   (d) Other reasons that might justify re-exposure (paragraphs 38-40)

   (e) Questions for the IASB

Background and context

5. At present, IFRSs have no credible standard that deals with the accounting for insurance contracts. IFRS 4, published in 2004, is an interim standard that permits a wide range of practices and includes a 'temporary exemption' that states explicitly that an insurer does not need to ensure that its accounting policies are relevant to the economic decision-making needs of users or are reliable. As a result, there are "substantial differences used by different companies to account for [insurance] contracts"[1].

6. Accordingly, the diversity in current application of IFRSs for insurance contracts today means that until a standard on insurance contracts is finalised, IFRSs could be regarded as incomplete. The IASB's project on insurance contracts is intended to address these problems by:

   (a) Providing a comprehensive framework that will require insurers to provide information that is relevant to users of financial statements for economic decision-making through transparent reporting of changes in the insurance contract liability and in the economic value of embedded options and guarantees.

[1] November 2011 SEC staff paper *An analysis of IFRS in Practice*.

(b) Eliminating inconsistencies and weaknesses in existing practices.

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

7. The fundamentals of the model, if finalised in a standard, would achieve these objectives, and would introduce consistency in the accounting for insurance contracts, regardless of the detailed decisions the Board is yet to take.

8. The IASB has been consistently told that there is an urgent need to finalise a standard on insurance contracts. However, the IASB has also had to balance the need to finalise a standard on insurance contracts with the desire to work towards a standard that is converged or substantially converged with US GAAP. The difficulties in balancing finalisation with convergence have been greater for the IASB than for the FASB because US GAAP for insurance contracts has been in place for many years and thus there is greater comparability between the financial statements of different insurers applying US GAAP than there is between the financial statements of different insurers applying IFRSs. Nonetheless any standard that the IASB finalises is likely to significantly improve comparability and consistency in the accounting for insurance contracts, regardless of whether that standard is fully or partially converged with US GAAP. Agenda paper 2 *Cover note* for the joint meeting describes the differences in views between the IASB and FASB.

The IASB's procedures for re-exposure

9. The IASB's Due Process Handbook states that:

> 46 After resolving issues arising from the exposure draft, the IASB considers whether it should expose its revised proposals for public comment, for example by publishing a second exposure draft.
>
> 47 In considering the need for re-exposure, the IASB:

- identifies substantial issues that emerged during the comment period on the exposure draft that it had not previously considered
- assesses the evidence that it has considered
- evaluates whether it has sufficiently understood the issues and actively sought the views of constituents
- considers whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions on the exposure draft.

48 The IASB's decision on whether to publish its revised proposals for another round of comment is made in an IASB meeting. If the IASB decides that re-exposure is necessary, the due process to be followed is the same as for the first exposure draft.

10. On 8 May 2012, the Trustees of the IFRS Foundation published for public comment a draft of an updated version of the IFRS Foundation Due Process Handbook. The comment period ended on 5 September 2012. The draft Due Process Handbook has substantially the same criteria for re-exposure and in addition states:

Completion of the deliberations

6.22 When the staff consider that the IASB has reached general agreement on the technical matters in the project and has considered the likely effects of the new IFRS, the staff present a paper to the IASB:

(a) summarising the steps the IASB has taken in developing the IFRS, including a summary of when the IASB discussed this project in public meetings, public hearings held, outreach activities, meetings of consultative groups and consultations with the Advisory Council;

(b) if applicable, reaffirming why the IASB has decided that it was not necessary to have a consultative group or to have conducted fieldwork; and

(c) assessing whether the proposals can be finalised or whether they should be re-exposed.

> 6.26 The IASB's decision on whether to publish its revised proposals for another round of comment is made in an IASB meeting. If the IASB decides that re-exposure is necessary, the due process to be followed is the same as for the first exposure draft. However, because it is not the first exposure of the proposed IFRS, it may be appropriate to have a shortened comment period, particularly if the IASB is only seeking comments on specific aspects of the revised exposure draft. The IASB normally allows a minimum period of 60 days for comment on a revised exposure draft.

11. Agenda paper 16E *Due process summary for the insurance contracts project* provides the information referred to in paragraph 6.22(a); this paper provides the information referred to in paragraph 6.22(c). (Paragraph 6.22(b) does not apply).

12. If re-exposure is not necessary, the staff intend to develop a review draft of the new insurance contracts standard which we would:

    (a) make generally available, via the IASB's website, for interested parties to review;

    (b) use as the basis for testing and outreach with parties that are most affected by the proposed new requirements; and

    (c) use as part of the fatal flaw review process the IASB is required to undertake.

13. As with the review draft of forthcoming general hedge accounting requirements, the IASB would not seek comments on the review draft, which would be made available for information purposes to enable constituents to familiarise themselves with the document.

14. Review drafts are not mentioned in the existing Due Process Handbook. However, the May 2012 draft of the IFRS Foundation Due Process Handbook describes a review draft as follows:

> *Review drafts*
>
> 3.29 The IASB normally seeks input on the drafting from people outside of the IASB. For convenience, a draft of a due process document made available to parties outside of the IASB is

referred to as a review draft. A review draft might be distributed to a selected group of reviewers, such as members of a consultative group, the Interpretations Committee, other standard-setters or parties that have provided feedback on the project. It may also be made available on the IFRS Foundation website.

3.30 Reviewers are asked for feedback on whether the draft document is clear and reflects the technical decisions made by the IASB. A review draft does not include an *invitation to comment* because the purpose of such a review is not to question the technical decisions. Because reviewers are conveying their personal views rather than those of their organisations, their comments are not normally made public.

3.31 It is normal for the IASB to use external reviewers before it finalises any new IFRS or major amendments. The nature of the external review, such as who is asked to review the draft and whether the draft is also made publicly available, is at the discretion of the IASB. The staff must also decide whether a review draft should be developed before the first pre-ballot draft is circulated to IASB members or whether one of the ballot drafts should be used for this purpose.

3.32 Although it is not a mandatory step to use external reviewers, if the IASB does use them, it must include in its report to the DPOC the extent to which external reviewers were used.

15. Applying this guidance, the following table summarizes the differences that the staff would expect to see between a “Review draft” and a revised Exposure Draft for the insurance contracts project. As discussed below, the IASB’s tentative decisions differ from the July 2010 ED in limited areas. Therefore the staff have assumed that a revised exposure draft would be targeted to seek input on those areas only, and not to re-open other aspects of the project. However, we note that a targeted exposure draft increases the risk that the IASB may not obtain balanced

views on proposals that it did not target in the invitation to comment, should it later decide to revisit any such proposals.

	Review Draft	Revised Exposure Draft
Objective	To assess whether the draft document is clear and reflects the technical decisions made by the IASB.	To obtain views of constituents on technical decisions made by the IASB.
Content	• summary and introduction • standard • implementation guidance • basis for conclusions • consequential amendments	• summary and introduction • standard • implementation guidance • basis for conclusions and analysis of effects • consequential amendments • snapshot
Exposure period	No official comment period. If the IASB decides to publish a review draft we will assess how much time is needed for constituents to consider the review draft.	The draft Due Process Handbook published in May 2012 proposes that there should be a minimum period of 60 days for comment on a revised exposure draft. However the staff would propose a 4 month comment period for this project (potentially longer subject to constraints arising from year-end reporting demands)
Feedback reporting process	Because reviewers are conveying their personal views rather than those of their organisations, their comments are not normally made public The IASB would consider in a public meeting any sweep issues arising from feedback (i.e. previously unidentified significant issues other than drafting improvements and other than clarifications within the boundaries of the IASB's previous decisions). After the review period has ended the IASB would be asked to confirm its decision not to re-expose the	The IASB would redeliberate the topics on which it invited comment. Comment letters would be available to the public through the IASB's website and a staff paper analysing the comments would be publicly available.

	revised insurance contracts standard.	
Estimated timing of final standard	September 2013	Depending on the number of questions asked in the invitation to comment, the staff expects that the earliest we could prepare a draft of the final IFRS is May 2014.

Revisions to the Exposure Draft

16. The following table summarizes the changes to the Exposure Draft as a result of the Boards' redeliberations in response to concerns expressed in the comment letters to the Exposure Draft. We use the following symbols to indicate status:

Key:

- ✓ Confirmation of proposal
- \+ Additional guidance provided
- ❖ Minor change
- ! Significant change from ED

	ED proposal	Tentative decisions	Staff comment
	Identifying the contract the standard applies to		
1	**Definition and scope** Apply standard to: • Insurance contracts with specified exceptions • Reinsurance assets that insurer holds • Financial instruments with discretionary participation features	✓ Confirm proposed definition of insurance contract ✓ Confirm standard would apply to financial instruments with discretionary participation feature ❖ But only if issued by insurers ✓ Confirm most scope exceptions ❖ Additional criteria for fixed fee service	No significant change from the ED.

	ED proposal	Tentative decisions	Staff comment
		contracts ❖ Exclude financial guarantee contracts unless previously regarded as an insurance contract (reverts to existing exclusion from scope of IFRS 4).	
2	**Unbundling (see also item 12)** Unbundle components not closely related to insurance contract: • Some account balances • Embedded derivatives • Some goods and services Prohibit unbundling that is not required	❖ Unbundle: ✓ Embedded derivatives not closely related to host insurance contract ✓ Distinct goods and services, identified using the approach proposed in the project on revenue recognition ✓ Distinct investment components that are not interrelated with the insurance component (See also item 12.) ✓ Prohibit unbundling that is not required	We have clarified the unbundling requirements proposed in the ED. We have also required the unbundling of fewer investment components than had been proposed in the ED. (see also item 12)
3	**Recognition point** Recognise when insurer is bound or first exposed to risk from contract	❖ Recognise when coverage period begins ❖ Onerous test before then	Change is a practical accommodation in response to issue identified in comment letters

	ED proposal	Tentative decisions	Staff comment
4	**Contract boundary** Ends when insurer: • No longer required to provide coverage or • Can set price that fully reflects risk of ***particular policyholder***	✓ Confirm ED proposal + Add clarification: risk can be assessed at ***portfolio*** level in some cases	Change is a practical accommodation in response to issue identified in comment letters
	Measure the contract		
5	**Fulfilment cash flows** • Expected value of cash flows incurred in fulfilling the contract, considering all relevant information	✓ Confirm use of expected value + Add guidance that not all possible scenarios need to be identified and quantified	No significant change from ED
	• Include only acquisition costs incremental at ***contract*** level	❖ Include all direct costs incurred in originating a ***portfolio*** of insurance contracts	In response to comment letters, we extended the principle that measurement applies at a portfolio level to the acquisition costs included in the cash flows.

	ED proposal	Tentative decisions	Staff comment
6	**Discount rate** • Adjusts future cash flows for time value of money • Reflects only the characteristics of the insurance contract liability • Current and updated each reporting period	✓ Confirm discount rate ✓ Do not prescribe method + Add guidance: • 'Top-down' and 'bottom-up' both acceptable • Remove any factors that influence observable rates not relevant to the liability ❖ Disclose yield curve or range of yield curves used.	No change in principle from ED. We made a practical accommodation in response to questions about how to determine an illiquidity premium. We expect that clarification will have the result that high volatility in market liquidity premiums will not result in highly volatile profit.
7	**Risk adjustment** • Include explicit estimate of the effects of uncertainty about future cash flows.	✓ measurement of liability should include explicit risk adjustment	No change from the principle in the ED, however some changes in application in response to the comment letters, as discussed below.
	• Objective: "The maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate cash flows exceed those expected."	❖ Objective: "The compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract." + Supplemented by application guidance	Clarification of objective in response to comment letters

	ED proposal	Tentative decisions	Staff comment
	• Reflects only those effects of diversification that arise within a portfolio	❖ Reflects diversification to the extent considered by the insurer in assessing the compensation it requires for bearing risk.	Change in response to concerns in comment letters that restricting the diversification benefit to the portfolio level is inconsistent with the entity-specific objective for the risk adjustment.
	• Techniques for measurement restricted to one of three	❖ No specification of technique to be used to meet objective	Change in response to concerns raised in comment letters that it is inconsistent with the underlying principle to restrict the techniques available to measure the risk adjustment.
	• Disclose confidence level equivalent disclosure	✓ Disclose confidence level equivalent disclosure	Confirmed proposal in ED.
8	**Residual margin** • Include residual margin and, as a result, recognise no gains at inception	✓ Confirm residual margin and, as a result, no gain at inception	No change to ED

	ED proposal	Tentative decisions	Staff comment

	• Residual margin locked-in at inception
	
	• Residual margin allocated
	  • Over coverage period
	  • On a systematic basis as follows:
	    • On the basis of the passage of time, but
	    • on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time
		! Adjust residual margin prospectively for changes in estimates of cash flows (unlocking)
		✓ Do not adjust residual margin for changes in risk adjustment
		
		Residual margin allocated:
		✓ Over coverage period
		❖ On a systemic basis that is consistent with the pattern of transfer of the services provided
			Significant change to proposals in ED. Possible re-exposure candidate, see below.

9	**Link to underlying items** • Discount rate reflects dependence of cash flows on specific assets	✓ Confirm discount rate reflects dependence of cash flows on specific assets ❖ Introduced “mirroring”: ❖ Adjust cash flows to reflect the measurement	Change from ED introduced in response to comment letters about the accounting mismatch that would arise for participating

	ED proposal	Tentative decisions	Staff comment
		basis of the items underlying participation ❖ Present changes in estimates consistently with equivalent changes in underlying item	contracts if the underlying items were measured on a basis other than fair value through profit and loss. However this approach was not discussed in the ED explicitly. Therefore re-exposure candidate.
10	**Measuring the reinsurance asset** • Use same estimates for reinsurance asset and underlying direct insurance liability • Losses at inception recognised over contract term • Gains at inception recognised immediately	✓ Confirm use of same estimates for reinsurance asset and underlying direct insurance liability ❖ Recognise any profit the reinsurer will earn immediately if for past events, otherwise over coverage period ❖ Recognise any profit the cedant will earn over coverage period	Changes to ED in response to concerns raised in the comment letters about day 1 gains
11	**Simplified measurement for some contracts** • Premium allocation approach ***required*** for contracts with coverage period of approximately 12 months	❖ Premium allocation approach ***permitted*** ❖ when reasonable approximation to the building block approach, ie if: • significant change not likely to occur before the claims is	Changes to ED to improve consistency with the IASB's view that the premium allocation approach could be used as a proxy for the measurement of the

	ED proposal	Tentative decisions	Staff comment
		incurred; and • significant judgement needed to allocate premium ❖ if coverage period is 12 months or less	liability for remaining coverage.
	• In premium allocation approach: • Require discounting and accretion of interest • Recognise all onerous contracts	In premium allocation approach: ❖ Reflect time value of money if financing element significant ❖ need not discount liability for remaining coverage when less than 12 months between payment and satisfying obligation ❖ Onerous contract test when facts and circumstances indicate contract might be onerous ❖ Discounting of liability for incurred claims if claims expected to be settled within 12 months	Changes made in response to concerns in comment letters that the premium allocation approach was overengineered and could be simplified.
	Present the results		
12	• No volume information: All premiums treated as deposits, all payments as return of deposits	✓ Present volume information on face of statement of comprehensive income ✓ Exclude from that volume information: (1) amounts the insurer is obligated to pay policyholders regardless of whether an	Significant change to the ED, possible re-exposure candidate. We will discuss the allocation of premiums to the statement of

	ED proposal	Tentative decisions	Staff comment
		insured event occurs and (2) other investment components, if distinct and not interrelated with the insurance component	comprehensive income in a future meeting.
13	• All changes in estimate presented in profit and loss	✓ Present in OCI changes in the insurance liability arising from changes in the discount rate	Significant change to the ED, possible re-exposure candidate.
14	• Disclosures	✓ Most disclosures confirmed	No significant change from ED to date. We will review existing decisions and discuss whether any other decisions need to be taken in a future meeting.

Questions for the IASB

Questions
Are there any issues that the IASB would like to revisit before finalising the next due process document?

Candidates for re-exposure

17. As shown in the table above, there are four changes to the proposals in the ED that might warrant re-exposure:

    (a) The requirement that the cash flows used to measure participating contracts should be based on the cash flows used to account for the underlying items

    (b) The requirement to present premiums in the statement of comprehensive income, which has two consequential decisions:

        (i) the part of the premium that relates to investment components is excluded from the premium presented in the statement of comprehensive income

        (ii) the premiums are allocated in the statement of comprehensive income on an earned basis (to be discussed at a future meeting).

    (c) The requirement to use the residual margin to offset changes in estimates of future cash flows

    (d) The requirement to present in other comprehensive income changes in the discount rate used to measure the insurance contract liability.

18. These changes are described further below.

Participating contracts

19. All tentative decisions of the boards equally apply to contracts with performance sharing mechanisms. However, two tentative decisions are of particular relevance to, and apply only to participating contracts:

    (a) To the extent that 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 discount rate should reflect that

dependence. This confirms, with some clarification, a proposal in the ED.

(b) The insurer should eliminate from the expected present value of the fulfilment cash flows changes in value not reflected in the measurement of the underlying items. In the proposals in the ED, the obligation to pass on returns from underlying assets is measured consistently with underlying assets that are measured at fair value through profit or loss. Thus, to the extent that policyholders participate in the returns of the underlying assets, the ED depicted that the insurer will settle that part of its obligation by delivering those assets to policyholders. The new decision would extend that approach to cases where the assets are not measured at fair value through profit and loss.

20. These changes were made in response to comments that an accounting mismatch would arise for participating contracts if the underlying items were measured on a basis other than fair value through profit and loss. We plan to review the interaction between these decisions and the IASB's other tentative decisions at a future meeting.

Premiums in the statement of comprehensive income

21. The ED proposed a summarised margin approach that presents all premiums as deposits and all claims and benefits payments as returns of deposit. Thus there was no 'volume' information in the statement of comprehensive income, although the disclosure requirements would have required an insurer to disclose such information. The relevant extracts from the Basis for Conclusions for the IASB's decisions on presentation are in appendix A.

22. However, since the ED, the IASB and FASB have been persuaded that the financial statements of insurers would be more understandable to non-specialist users, and more useful, if the statement of comprehensive income were to include volume information. Accordingly the IASB and FASB propose that information

about premiums, claims and expenses should be provided in the statement of comprehensive income.

23. Underpinning this decision is the desire to improve consistency with the concept of revenue. Consistency with the concept of revenue would have two important consequences:

    (a) the part of the premium that relates to investment components is excluded from the premium presented in the statement of comprehensive income. Some suggest that excluding that part of the premium would be onerous. Nevertheless, the revised decisions would be easier to apply than the unbundling of explicit account balances which had been proposed for some contracts in the exposure draft, and thus the revised decision can be applied to a greater number of contracts with investment components. This provides a better basis for comparison as the accounting would be based on the economics of the contract rather than the form of the contract. However the revised decision would be more difficult to apply than the ED if the proposals in the ED would not have required unbundling, for example for contracts where the investment component is implicit, rather than explicit.

    (b) the premiums are allocated in the statement of comprehensive income on an earned basis. We plan to discuss this issue at a future meeting.

24. Arguably, the IASB's decision on premiums in the statement of comprehensive income need not be exposed because it responds directly to the requests in the comment letters and applies principles from the board's revenue recognition model. However, because there may be operational challenges in applying the decision to exclude deposit components from premiums and in determining earned premiums (if the IASB adopts that route), the IASB might gain benefit from input on the relative cost and benefit of the proposals, either through field work or through re-exposure.

Offsetting changes in estimates of future cash flows in the residual margin

25. The ED proposed that all changes in estimates are recognised immediately in profit and loss and as an adjustment to the insurance liability. The reasons for that decision are set out in the extract of the Basis for Conclusions reproduced in Appendix A.

26. However, in response to the comment letters the IASB revised this decision because it was persuaded that offsetting changes in estimates of future cash flows would provide better information for users of financial statements. The reasons are:

    (a) It would reflect a view of the residual margin as the unearned profit in the contract. Applying this view, the residual margin should be measured as the difference between the premiums and the estimates of the cash outflows. If the cash outflows increase, the contract becomes less profitable and the residual margin decreases accordingly. If the increase relates to estimates of future cash flows (as opposed to experience adjustments), the increase reduces the unearned component of the residual margin. Consequently a change in the estimate of the future cash flows should be viewed as a transfer between the components of the total liability, i.e. offset against the residual margin.

    (b) It would avoid outcomes that some people regard as counterintuitive. Immediate recognise of adverse changes in estimates can make contracts that are profitable overall appear to be loss-making in some years. It can also make contracts that actually become loss-making overall appear to be profitable in later years.

    (c) An approach that offsets changes in estimates against the residual margin could help prevent manipulation of profits. Applying the original proposals, an insurer might over-estimate the fulfilment cash flows on ‘day 1’ of the contract. On ‘day 2’ it could revise the estimates down and recognise the difference as an immediate gain. In contrast,

applying the revised approach, the insurer would recognise the difference as an adjustment to the residual margin. The outcome would be the same as if the insurer had correctly estimated the fulfilment cash flows on day 1. The insurer would not recognise an immediate gain.

27. As a result, the IASB concluded that an insurer should offset a net increase in expected future outflows against the residual margin and should add a net decrease in expected future outflows to the residual margin. Consequently, a decrease (or increase) in the contract's expected profitability arising from changes in estimates of future cash flows would not be recognised immediately (except to the extent that a decrease exceeded the residual margin available for offset, i.e. if the contract became onerous). It would be recognised implicitly in subsequent periods, when the residual margin is released to profit or loss. This is sometimes referred to as 'unlocking'.

28. An effect of 'unlocking' the residual margin in the manner summarised in the previous paragraph is that it 'locks' the liability as a whole (except to the extent that the contract becomes onerous). The liability is locked at an amount equal to the premiums received from the policyholder for services not yet provided. Thus, the effect of 'unlocking' the residual margin is to make the building block approach more like the model proposed in the revenue recognition project.

29. Arguably, the decision to offset changes in estimates of future cash flows does not warrant re-exposure. This change was made in response to the comment letters on the exposure draft and has been widely supported, most recently at the June Insurance Working Group meeting.

30. However, in favour of re-exposure:

    (a) this approach is potentially more complex to apply than recognising such changes in profit or loss because it could require tracking of information about contracts from inception and may result in a smaller unit of account for releasing the residual margin in practice than might be required for a straight-line allocation of a locked residual margin.

Nonetheless the staff note that such operational considerations are similar to those required for other aspects of the model, eg in the use of other comprehensive income and the determination of earned premium.

(b) some have expressed concerns about the consistency of offsetting only changes in estimates of future cash flows in the residual margin, and not other changes in estimates or changes in the risk adjustment.

31. Therefore, the IASB may benefit from seeking further input on this issue, either through testing or through re-exposure.

Other comprehensive income

32. The ED proposed all income and expense from insurance contracts should be presented in profit or loss. Paragraphs BC177-BC180 of the Basis for Conclusions discussed the use of other comprehensive income, as described in Appendix A.

33. However, since the ED, the IASB and FASB have decided that changes in the insurance contract liability arising from changes in the discount rate should be presented in other comprehensive income. In their deliberations, the boards were persuaded that it would provide more useful information to users of financial statements if underwriting information were to be clearly separated from effects of changes in discount rates.

34. The IASB has since discussed this decision with the insurance working group (IWG). As noted in agenda paper 2 for the July 2012 IASB meeting:

> Some [IWG] participants expressed concerns about the treatment of loss sensitive cash flows and about the fact that the Board does not intend to include a test that would, without changing the measurement of the insurance contract liability, accelerate the recognition in profit and loss of some losses already recognised in OCI in the event that the assets provide lower than expected returns (sometimes called a 'loss recognition test').

> Most importantly, many were concerned that an accounting mismatch would arise from requiring changes in the insurance liability to be presented in OCI, while the assets will be measured using a mixture of fair value through OCI, fair value through profit and loss and amortised cost. Participants stated that this approach would not measure assets and liabilities on a consistent basis. Many participants suggested this problem could be dealt with through an option to present all changes in the insurance contract liability in profit and loss. However, an option to present all changes in profit and loss was not universally supported, especially by the users. However, though they believed that there should be no optionality in the accounting treatments they were also concerned that the board's tentative decisions would not provide useful information if the resulting accounting mismatch caused two volatile numbers: one in profit and loss and one in OCI.

35. The staff believes that the IASB may find benefit in seeking input, either through testing or through re-exposure, on its decisions on other comprehensive income to help it understand:

    (a) the differing (and strongly held) views expressed by interested parties, and the different effects on entities with different asset mixes

    (b) the operational complexity that would result by presenting in profit and loss changes in cash flows that result from changes in discount rate.

Other changes to the ED

36. Apart from the changes identified in paragraph 17 and discussed in paragraphs 19-35, the staff believes that the changes to the ED are not candidates for re-exposure. The staff observes that most of the changes made had been in response

to concerns and suggestions made in the comment letters and subsequent outreach and can be classified as follows:

(a) The change is to an alternative that was rejected by the IASB in the Basis for Conclusions to the ED, but which the IASB has reconsidered, based on the relative weighting of arguments following review of the comment letters and other outreach.

(b) The change is a practical accommodation in applying the principles in the ED which has been made in response to concerns raised by interested parties.

(c) The change clarifies the IASB's intentions in the ED (either by articulating the proposals differently or by adding guidance) and has been made in response to concerns that interested parties identified as they sought to interpret the ED.

(d) The change simplifies the proposals in the ED, usually in response to concerns raised in the comment letters.

37. Many of the changes do not differ significantly to the proposed requirements in the 2010 ED on which the IASB has received extensive feedback. Hence, if the IASB issues a revised Exposure Draft, the staff thinks that the IASB does not need to seek specific comment on all those changes.

Other reasons that might justify re-exposure

38. Some constituents think it would be appropriate to issue a revised Exposure Draft that invites comment on all aspects of the revised requirements. Those constituents cite the precedent they believe has been set in the IASB's projects on revenue recognition and leases and suggest that a full re-exposure is the only way to ensure a high-quality standard because of the breadth of scope of the insurance contracts project for insurers and the resulting risk of unintended consequences.

39. The IASB's procedures for re-exposure suggest that re-exposure would be needed if constituents have not had an opportunity to comment on a proposal. The staff think that the IASB has provided constituents the opportunity to comment as follows:

    (a) The core principles in the Exposure Draft have remained largely intact. The changes to the Exposure Draft mostly clarified or simplified the application of those principles (and in some cases have resulted in accounting that is more consistent with existing requirements and practices). Hence, the staff thinks that constituents have had an opportunity to comment on the core principles in the insurance contracts model.

    (b) During redeliberations, the IASB has made extensive efforts to consult interested parties and to assess whether there are unintended consequences. Those efforts are described in agenda paper 16E *Due Process Summary for the Insurance Contracts project*. The staff has also made available on its public website reports of the board's tentative decisions in some areas and extracts of a working draft implementing those decisions and invited comment specifically on unintended consequences.

    The IASB could continue to provide constituents the opportunity to comment on its tentative decisions through an outreach programme during the period a review draft was made available on the public website.

40. One concern about re-exposure would be that some constituents may treat the re-exposure as an opportunity to reopen discussion on matters that the IASB regards as being resolved (such as the core principle of a current, market-consistent measurement model for insurance contract liabilities), even if the IASB were to

limit the questions in the invitation to comment to specific topics[2]. In the staff's view, the IASB should seek to avoid redeliberating topics not targeted in the invitation to comment. Doing so could significantly delay the issuance of the final standard beyond the time indicated in paragraph 10. But more importantly, if the IASB were to decide after publishing the ED to redeliberate topics not targeted in the invitation to comment, the IASB needs to be aware that the comment letters might not provide a balanced range of views. This is because only those who disagreed with a topic not discussed in the invitation to comment are likely to discuss it in the comment letters. That could result in decision-making based on incomplete information.

Questions for the IASB

Questions
Does the IASB want to: (a) issue a Review draft, or (b) issue a revised Exposure Draft?

[2] Although the questions in the invitation to comment would be targeted, the Exposure Draft would set out the whole of the draft IFRS.

Appendix A: Relevant extracts from the Basis for Conclusions to the ED

Extract of Basis on offsetting changes in estimate in residual margin

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 followingparagraphs.

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.

Extract of Basis on presentation

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:

(c) 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.

(d) 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 nonparticipating 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).[3]

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.

[3] The IASB's tentative decisions for participating contracts would retain this second form of shadow accounting.