STAFF PAPER

November 2016

IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Other sweep issues		
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Purpose of this paper

1. This paper summarises issues that have arisen in the drafting process and external testing that are not addressed in the other papers at the November 2016 International Accounting Standards Board (Board) meeting (ie sweep issues). It includes the most significant changes that the staff has made to the pre-ballot draft of IFRS 17[1] (draft IFRS 17) in the light of comments from Board members comments, the topic-based testing, and external review.

2. The staff proposes to discuss the issues in this paper with the Board on an exceptions basis, ie the staff will ask only a general question as to whether the Board agrees with the staff's proposals. We would discuss an issue only if requested to do so by a Board member. The staff asks for advance notification from Board members if they intend to discuss any issues to assist in meeting planning.

Question for Board members: Sweep issues
1. Does the Board agree with the staff proposals for resolving the remaining sweep issues?   2. Are there any other topics that Board members would like staff to consider at a future meeting?

[1] The pre-ballot draft is the same draft of IFRS 17 that was used by the external test participants.

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Issues and proposed staff action

Issue	Paragraph in draft IFRS 17	Topic	Issue	Proposed action
1	14	Contract combination	Test participants were concerned that the requirements in paragraph 14 of draft IFRS 17 may cause contracts to be combined inappropriately. For example, contracts are issued separately, but the pricing reflects the existence of another contract (for instance when a discount is given when two modules are bought) with the result that they would be required to be combined. However, in many cases, test participants thought that combining contracts in these situations would not be appropriate. One factor raised was that for management purposes and/or from a systems perspective the contracts may be managed separately and the connection between contracts would not be apparent after origination.	Paragraph 14 was added to the 2013 ED to be consistent with paragraph 17 of IFRS 15, which also addresses the combination of contracts. However, paragraph 14 results in unintended consequences which are not present for IFRS 15, because IFRS 15 requires that once contracts are combined, separate performance obligations are identified and accounted for separately. The staff propose to delete paragraph 14 and instead refer to the general principle in IFRS that the substance of contracts should be followed, and which is proposed to be included in the *Conceptual Framework* by paragraph 4.56 of the *Conceptual Framework* Exposure Draft: "4.56 A group or series of contracts may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the group or series of contracts as a

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				whole. For example, if the rights or obligations in one contract entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist. Conversely, if a single contract creates two or more sets of rights and obligations that would have been identical if each set had been created through separate contracts, the entity may need to account for each set as if it arose from separate contracts in order to faithfully represent the rights and obligations (see paragraphs 4.57–4.63)."
2	16	Unbundling of embedded derivatives	Paragraph 16 of draft IFRS 17 specifies that an entity shall separate from a host contract an embedded derivative if, and only if, the embedded derivative meets both of the following criteria: (i) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see paragraphs B4.3.5 and B4.3.8 of IFRS 9); and (ii) A separate financial instrument with the	The staff propose that to remove the separation criteria for embedded derivatives from IFRS 17 and instead require that an entity apply IFRS 9 to determine whether there is an embedded derivative to be separated and, if so, how to account for that derivative. This is consistent with the approach taken with other non-financial-asset hybrids. No difference in outcome is expected.

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			same terms as the embedded derivative would meet the definition of a derivative in accordance with IFRS 9 and be within the scope of IFRS 9 (for example, the derivative itself is not an insurance contract). These conditions were adapted from paragraph 4.3.3 of IFRS 9 and were intended to result in the same outcome as applying the separation criteria in IFRS 9. However, it is potentially confusing to use similar wording that addresses the separation of embedded derivatives in both IFRS 9 and IFRS 17.	
3	16	Separation of embedded derivatives	A few test participants suggested that the Board retain the effect of the option in IFRS 4 that permits an entity to separate from a host contract an embedded derivative that itself meets the definition of an insurance contract. The change in the fair value of the embedded derivative would offset the fair value changes of standalone financial derivatives in the statement of profit of loss while the host contract (either a deposit contract or an	The staff note that this suggestion relates to embedded derivatives that would not be separated from the insurance contract applying the requirements for separation of embedded derivatives in IFRS 9. The staff note that the Board has previously rejected voluntary unbundling of components that do not meet the requirements for unbundling because permitting an option to unbundle would reduce comparability

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			insurance contract) would be measured at cost. In contrast, IFRS 17 will require the entire contract to be measured on a 'fulfilment cash flow' basis.	among insurers. No action proposed.
4	21	Pre-coverage cash flows	Questions arose as to what was intended by "pre-coverage cash flows".	Acquisition costs are defined as the costs of selling, underwriting and initiating an insurance contract. Only cash flows that meet the definition of acquisition costs could be incurred before the coverage period begins. Therefore, we propose to remove reference to 'pre-coverage cash flows' and refer only to 'acquisition costs'
5	41and 42	Order of the unlocking and release of the contractual service margin	A few test participants expressed concern that unlocking the contractual service margin before releasing an amount to profit or loss for the transfer of services would cause unnecessary operational burdens. Unlocking the contractual service margin before	This comment was made in the context of the draft requirements to adjust the contractual service margin for the combined effect of experience adjustments and consequential changes to the estimates of future cash flows. In Agenda Paper 2D, the staff recommend that such combined effects should not adjust the contractual service margin, so this operational complexity will not arise. The staff note that under the variable fee

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			releasing an amount for the transfer or services means that the amount released, and hence revenue for that period, includes the effect of changes relating to future service. One test participant questioned whether that was appropriate.	approach, it is necessary to remeasure (ie unlock) the contractual service margin before releasing an amount to profit or loss, in order to include the effect of the change in the entity's share of the underlying items in the period. The staff think that under the general model, the order is essentially arbitrary, and having a consistent order is better than having a different order in the general model and the variable fee approach. No action proposed.
6	48	Premium allocation approach	There were some questions about the application of the premium allocation approach: 1. Whether only the unwind of the discounting effect should be presented as part of financial result for contracts qualifying for the premium allocation approach, or if inflation should also be included. 2. Some asked for greater clarity on which contracts are intended to qualify for the premium allocation approach. Related to	1. The financial result will include the unwind of the discounting effect for the liability for remaining coverage for contracts qualifying for the premium allocation approach, if significant. Changes in inflation are not part of the financial result (see item 21). 2. The staff do not propose to modify the premium allocation approach to deal with more complex products. Contracts with a coverage period of 12 months or less are

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			this question, some asked if the premium allocation approach could be modified to assist in dealing with more complex products.	deemed not to be too complex to apply the premium allocation approach. Complexity may result in a contract with a coverage period of more than 12 months not meeting the eligibility criteria for the premium allocation approach. The staff will ensure the requirements are clear in drafting.
7	55	Reinsurance contracts held	There were some questions about reinsurance: 1. Some test participants stated that draft IFRS 17 should make it clearer that reinsurance contracts cannot be measured under the variable fee approach. 2. Some test participants mentioned that reinsurance contracts held (ie business ceded by the primary insurer) should be accounted for in a manner consistent with the underlying business to which they relate.	1. The staff propose to ensure this is clear in drafting. 2. Since the Board has previously debated this point and there is no new information, the staff propose no action.

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			3. A few respondents stated that the contract boundary of the reinsurance contract should mirror that of the underlying insurance contract in order for movements to be reflected at the same time. If the contract boundaries are not aligned it could cause a mismatch between the underlying CSM and the associated net gain/cost of reinsurance.	3. The Board in the past concluded that reinsurance contracts and the underlying reinsurance contracts are separate contracts that need to be measured separately, while ensuring consistent assumptions were used for both types of contracts. To align the boundaries of the two different contracts could be artificial, and not reflecting the economic differences between the contracts.
8	65	Contract modifications	Draft IFRS 17 specifies that in some cases, assessments made at contract assessment affect the accounting model that applies to the contract. As a result, the 2013 ED proposed that if an entity modifies a contract in a way that would have resulted in a different assessment had the modification been in place at inception, the entity would derecognise the original contract and recognise the modified contract instead. The 2013 Exposure Draft *Insurance Contracts* specified that this would be the case if any of the following	The staff intend to amend draft IFRS 17 so that the addition of a component that would have been unbundled if it had been present at inception to the conditions that would result in derecognition of the original contract and recognition of a new contract.

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			conditions are satisfied: (i) The modified contract would have been excluded from the scope of IFRS 17 if it had been written at contract inception with the modified terms. (ii) The entity applied the premium-allocation approach to the original contract, but the modified contract no longer meets the eligibility criteria for that approach. (iii)The modified contract would have been included in a different portfolio from the one in which it was included at initial recognition if it had been written at contract inception with the modified terms. One commentator noted that it would be consistent with the Board’s logic to include in this list of conditions the addition of a component to the contract if that component would have been unbundled because it is an embedded derivative, a distinct investment component or distinct goods or	

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			services.	
9	73	OCI presentation for the finance element of the change in risk adjustment	Paragraph 73 of the draft IFRS 17 states that "an entity need not disaggregate the change in the risk adjustment between the insurance service result and insurance finance income or expense. If an entity does not make such a disaggregation, it shall present the entire change in the risk adjustment as part of the insurance service result." The question arises as to whether an entity that makes such a disaggregation should be permitted recognise part of the insurance finance income or expense relating to the change in the risk adjustment in profit or loss and other comprehensive income.	The staff propose to amend the draft to clarify that an entity is permitted to recognise part of the insurance finance income or expense relating to the change in the risk adjustment for a group of contracts in profit or loss and other comprehensive income, consistently with the way that the finance income or expense for that group of contracts as a whole is presented. This is consistent with the objectives for the insurance finance income or expense.
10	B68(k)	Mutualisation	Many test participants were unclear about the application of paragraph 68(k) of draft IFRS 17 and hence did not understand how draft IFRS 17 reflects the effect of mutualisation on the level of aggregation. Test participants also suggested that IFRS 17 should define "mutualisation."	The staff propose to add further guidance on how an entity should reflect mutualisation in determining the cash flows of a group of contracts and the consequent implications for the level of aggregation.

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11	B72	Accretion and unlocking of CSM	The staff observed that there are different discount rates used for different components of measuring an insurance contracts (locked-in vs current, risk-free vs weighted average reflecting asset dependency). The staff decided to reduce complexity by reducing the number of discount rates used by specifying the discount rate to be used on initial recognition for accreting the contractual service margin and adjusting the contractual service margin for contracts without direct participating features. The additional requirement is underlined in the following paragraph: For insurance contracts without direct participation features, in calculating the interest to accrete on the contractual service margin and in measuring the changes to the contractual service margin applying paragraphs 41.b and B91.a, the discount rate should be the rate applicable to nominal cash flows that do not depend on the returns on any underlying items.	The staff asks that the Board confirm this change.

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12	B97	Meaning of contractual terms in the scope of the variable fee approach	The definition of an insurance contract with direct participation features states that it is a contract for which, at initial recognition: (a) The **contractual terms** specify that the policyholder participates in a share of a clearly identified pool of underlying items; (emphasis added); (b) The entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and (c) A substantial proportion of the cash flows the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items. Most respondents questioned what is meant by “contractual terms”, specifically whether they include terms implied by constructive obligations or terms arising from law or regulation.	The Board’s intent for criteria (a) is that in contracts with direct participation features, the link to the underlying items, though subject to discretion, should be enforceable. Accordingly: - Consistent with paragraph 2 of the pre-ballot draft, the entity should consider all of the substantive rights and obligations that are held by the entity, whether they arise from a contract, law or regulation. - The notion of “enforceable” should be consistent with the requirements in paragraph 10 of IFRS 15, which states that “a contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity’s customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may

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				vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). - IAS 37 defines a constructive obligation as "an obligation that derives from an entity's actions where: (a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities." Thus, while a contract can arise because of constructive obligations, not all constructive obligations would give rise to contracts as defined by IFRS 15. We propose to add guidance on the scope of the

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				variable fee approach as above.
13	B97	Scope of variable fee approach	Some test participants asked for further guidance on how to interpret the scope of the variable fee approach including: - What does substantial mean? - Differences between criterion two and criterion 3. - Whether the variability in the expected cash flows should be considered over the entire contract term or for only the reporting period. - Whether cash flows could be assessed on an expected basis or on a worst outcome basis.	The Board developed the variable fee approach to apply to contracts in which the entity could be viewed as charging the policyholder a variable fee for the service of managing investments. When this is the case, the entity’s primary obligation is to pay to the policyholder an amount equal to the fair value of the underlying items, less the variable fee for service. Criteria 2 and 3 are intended to identify when the entity’s primary obligation is to pay to the policyholder an amount equal to the fair value of the underlying items, less the variable fee for service. Accordingly, the term ’substantial’ should be interpreted in that context. We propose to ensure that these points are clear in drafting, although we noted that the Board intends that terms such as “substantial” will be subject to judgment (ie the Board is intentionally not prescribing a bright line).
14	B97	Variable fee	Operational challenge of valuing underlying items	The variable fee approach is based on the premise

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		approach	at fair value, if the underlying item is not typically measured at fair value.	that the obligation of the entity is to pay the policyholder an amount equal to the fair value of the underlying items. The use of fair value is thus consistent with the economic position. IFRS 13 provides guidance on how to measure fair value. No action proposed.
15	B107	Coverage units	Some test participants asked for clarification as to what we intended by the reference to "coverage units" for the release of the contractual service margin to profit or loss. They were also concerned that the concept was introduced relatively late in the draft.	The staff propose to provide more guidance to explain that "coverage units" is a way to ensure that the release of the contractual service margin in each period reflects the duration and size of contracts in a group.
16	B114	Change in allocation pattern for a contract accounted for using the premium-allocation approach after initial recognition from one method to another	Paragraph B114 specifies that, when an entity applies the premium-allocation approach, insurance contract revenue for the period is the consideration to which the entity expects to be entitled in exchange for coverage and other services determined on the basis of the passage of time, but if the expected pattern of release of risk differs significantly from the passage of time, then on the	The objective for the allocation of the contractual service is that the entity recognises the remaining contractual service margin according to the remaining service to be provided. Permitting a prospective change in the allocation method is consistent with that objective. Therefore the staff proposes we do not prohibit an entity from changing allocation methods for the remaining

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			basis of expected timing of incurred claims and benefits. The question is whether an entity would be able to change between the different allocation methods.	unallocated premium.
17	Appendix C	Comparative information	Test participants indicated that an entity that files with the SEC would be required to provide 2 years of comparative information. The test participant suggested that the Board provide relief from providing comparative information for more than one period preceding the date of initial application, similar to the relief provided in IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosures of Interests in Other Entities*.	IFRS 10. C2A provides relief from the disclosure requirements of IAS 8 para 28(f) which requires explanation of the effects on the new standard for every period presented. IFRS 10.C6A-C6B provides transition relief for presenting comparative information. IFRS 12.C2A and IFRS 12.C2B provides transition relief for the disclosures for the comparative periods other than the year one preceding. The staff propose to add relief along the lines of C2A, C6A and C6B of IFRS 10 and C2A and C2B of IFRS 12[2]. The staff notes that

[2] The staff does not propose providing relief along the lines of IFRS 12.C4, which relates to whether an entity has changed from being consolidated to not consolidated from applying IFRS 10. That provides relief for a change in assessment (which affects recognition and measurement), which does not apply to IFRS 17

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				IFRS Standards generally require only 1 year of comparative information.
18	Appendix C	Transition for contracts previously acquired in a business combination	Some test participants stated that when an entity had acquisitions and business combinations that occurred before the date of transitioning to IFRS 17, the entity would need to calculate different contractual service margins for the consolidated and the separate financial statements of the subsidiary that issued the contract. This is because draft IFRS 17 requires that an entity use the fair value at the date of business combination or acquisition to determine the contractual service margin for the contracts in the consolidated financial statements. Some respondents asked if, given IFRS 17is to be applied retrospectively, whether entities would need to adjust the goodwill recognised under a business combinations that took place before transition	The issue of different contractual service margins is not a unique problem to transition and reflects that the reporting entity in consolidated financial statements acquired the contracts on a different date than inception of the contracts for the subsidiary. No action proposed. IFRS Standards do not generally require restatement of goodwill arising at the time of previous business combinations when new Standards require changes in measurement or recognition criteria for assets and liabilities. Furthermore, IFRS 3 *Business Combinations* was

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				applied prospectively from the date of initial application of that Standard, hence goodwill that arose from business combinations whose acquisition dates preceded the application of IFRS 3 was not adjusted. The staff intend to make clear that an entity does not restate goodwill of business combinations that occurred before the application of IFRS 17.
19	Throughout	Discount rates that reflect the characteristics of the cash flows	The feedback on the draft indicated that there would be a benefit in reviewing the description of the discount rates to be applied to determine fulfilment cash flows to ensure that the contract is measured on a market-consistent basis. In particular, some thought that parts of the draft suggested that the Board still expected that entities would be required to bifurcate the expected cash flows and apply different discount rates to those cash flows.	We propose to redraft the section on discount rates to be clearer that draft IFRS 17 does not require bifurcation of cash flows in this way, but that those paragraphs describe the outcome that an entity should reach in measuring insurance contracts.
20	Throughout	All available information	Draft IFRS 17 refers to the need to consider “all available information” in measuring insurance	The staff propose to review the wording in draft IFRS 17 and align it to IFRS 9 where appropriate.

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			contracts. Some suggested that the wording used needed to be consistent with similar wording in other IFRS Standards, for example in the IFRS 9 impairment requirements.	
21	Throughout	Inflation	Some test participants stated that the language in draft IFRS 17 on the accounting treatment for inflation is inconsistent. Additionally, it is unclear whether or not inflation should be treated as a market variable.	The staff propose to clarify that an inflation index is a financial variable, but inflation specific to a contract is a non-financial variable.