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KPMG
cutting through complexity

"This month's decisions indicate that the IASB is not only listening to constituent concerns, but responding to them."

Joachim Kölschbach,
KPMG's global IFRS insurance leader

MOVING TOWARDS INTERNATIONAL INSURANCE ACCOUNTING

This edition of *IFRS Newsletter: Insurance* highlights the IASB's discussion in March 2014 on its insurance contracts project.

Highlights

The IASB's March meeting saw the Board's first redeliberations on the proposals contained in its 2013 exposure draft, and focused on two of the five issues targeted.

Unlocking the contractual service margin

- Changes in the risk adjustment that relate to coverage and other services in the future would adjust the contractual service margin.
- Favourable changes in estimates that arise after losses have previously been recognised in profit or loss would be recognised in profit or loss to the extent that they reverse losses that relate to coverage and other services in the future.

Using OCI to present the effects of changes in discount rates

- An entity could choose as its accounting policy to present the effects of changes in discount rates in profit or loss or in OCI and apply that accounting policy to all contracts within a portfolio, subject to the IASB staff developing guidance:
  - confirming that entities would apply the same accounting policy to groups of similar portfolios; and
  - that would provide rigour about when entities could change accounting policies based on the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
- An entity would disclose an analysis of total interest expense.

TWO OF THE FIVE TARGETED AREAS DELIBERATED

The story so far …

The current phase of the insurance project was launched in May 2007, when the IASB published a discussion paper, *Preliminary Views on Insurance Contracts*. More recently, the IASB re-exposed its revised insurance contracts proposals for public comment by publishing the exposure draft ED/2013/7 *Insurance Contracts* (the ED) in June 2013. The IASB is expected to complete its redeliberations of the insurance proposals in 2014 and publish a final standard in 2015.

Interaction with other standards

Throughout its redeliberations, the IASB has considered many of the decisions made in the proposed financial instruments standard – including the way in which the standard might interact with the final insurance contracts standard – because the financial instruments standard will cover a large majority of an insurer's investments.

The Board has also considered whether the accounting for insurance contracts would be consistent with other existing or future standards, including the proposals on revenue recognition. Much of the guidance contained in the ED was designed to align with the IASB's and FASB's joint proposals on revenue recognition.

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What happened in March 2014?

At its March meetings, the IASB focused on two proposals in the ED, and discussed:

- unlocking the contractual service margin; and
- using other comprehensive income (OCI) to present the effects of changes in discount rates.

The Board considered the feedback received on the proposals for unlocking the contractual service margin and decided that:

- changes in the risk adjustment that relate to coverage and other services in the future would adjust the contractual service margin; and
- favourable changes in estimates that arise after losses were previously recognised in profit or loss would be recognised in profit or loss to the extent that they reverse losses related to coverage and other services in the future – any excess of favourable changes in estimates over the losses previously recognised in profit or loss would rebuild the contractual service margin.

Many respondents to the ED suggested that the use of OCI to present the effects of changes in discount rates should not be mandatory, but optional. The IASB considered the respondents' feedback and decided that an entity could choose as its accounting policy to present the effects of changes in discount rates in profit or loss or in OCI and apply that accounting policy to all contracts within a portfolio, subject to the IASB staff developing further guidance.

In addition, the Board decided that an entity would disclose an analysis of total interest expense to explain the effects of changes in discount rates.

This month's Board decisions related only to non-participating contracts. The IASB will consider issues related to participating contracts at a later stage and then consider whether it needs to revisit the decisions for non-participating contracts.

At next month's meetings, the IASB is expected to discuss:

- the presentation of insurance contract revenue; and
- the approach for redeliberating other issues on which the IASB did not request feedback.

The staff noted that the IASB is expected to complete its redeliberations of the insurance proposals in 2014 and publish a final standard in 2015. Next month's decisions may further substantiate the expected timeline.

Changes in the risk adjustment that relate to coverage and other services in the future would adjust the contractual service margin.

Changes in the risk adjustment

What's the issue?

The ED proposed that the contractual service margin would be adjusted – i.e. unlocked – for differences between current and previous estimates of the present value of future cash flows relating to coverage and other services in the future. However, changes in the risk adjustment would be recognised in profit or loss.

In developing these proposals, the IASB determined that changes in the risk adjustment comprised three components:

- a release from risk as the coverage period expires;
- changes in risk that relate to future coverage periods; and
- changes in risk that relate to incurred claims.

When developing the ED, the IASB considered that most changes in the risk adjustment would relate to the expiry of coverage – and it would be difficult to divide the risk adjustment into a part relating to a future period's coverage and a part relating to past and current periods' coverage. The IASB had therefore decided that it would be more transparent to report changes in risk relating to expected changes in circumstance in profit or loss.

Only a few respondents supported the IASB's proposals to recognise all changes in the risk adjustment in profit or loss. Most constituents believed that a better approach would be to:

- adjust the contractual service margin for changes in the risk adjustment that relate to future coverage; and
- report the change in the risk adjustment relating to current and past coverage in profit or loss.

What did the staff recommend?

The staff recommended that the Board confirm the proposals in the ED to unlock the margin for differences between current and previous estimates of the present value of cash flows relating to coverage and other services in the future after inception, subject to the limitation that the margin cannot become negative.

The staff also recommended that differences in the current and previous estimates of the risk adjustment relating to coverage and other services in the future should unlock the contractual service margin – but not to the extent that they result in a negative margin. Accordingly, changes that relate to coverage and other services provided in the current and past periods should be recognised in profit or loss.

The staff presented the following arguments.

- The contractual service margin is the risk-adjusted profit for the contract to be earned as the coverage and other services in the future. The staff proposal would therefore increase the consistency of the margin determined at inception and on subsequent measurements.
- The risk adjustment is a measure of the variability of the present value of cash flows – therefore, differences in the current and previous estimates of the risk adjustment should be treated consistently with changes in the current and previous estimates of the present value of cash flows to which the risk adjustment relates.
- It would be operationally viable to decompose the risk adjustment. The majority of constituents – particularly those in Europe, Australia and North America – indicated that it was relatively straightforward, and that existing methods for determining the risk adjustment already make this information available.

What did the IASB decide?

The Board agreed with the staff recommendations.

There was limited discussion by some Board members about whether the benefits of two margins continued to outweigh the costs of preparation if the contractual service margin is unlocked for changes in the risk adjustment.

A few Board members were concerned about how this proposal would operate in practice, because the risk adjustment may be determined at a less granular level than the contractual service margin (which is determined as the residual amount at a portfolio level). The staff agreed to provide clarification on the level of determination of the risk adjustment in the final standard.

KPMG insight

Adjusting the contractual service margin for changes in the risk adjustment relating to coverage and other services that are to be provided in future periods would increase complexity, because entities would need to decompose the changes in risk adjustment into:

- changes relating to current and past coverage; and
- changes in risk relating to coverage provided in future periods.

The IASB considered that the added complexity would be offset by the benefits of consistency in the treatment of gains and losses. Although many insurers observed that existing methods for determining the risk adjustment already make this information available, entities would need to consider how their systems would track and store this data. They would also need to amend financial reporting processes to calibrate this adjustment at each reporting period.

Favourable changes in estimates that arise after losses have previously been recognised in profit or loss would be recognised in profit or loss to the extent that they reverse losses related to coverage and other services in the future.

Treatment of previously recognised losses

What's the issue?

Under the proposals in the ED, once the contractual service margin has been exhausted:

- unfavourable changes between current and previous estimates of the present value of those cash flows would be recognised in profit or loss; and
- favourable changes between current and previous estimates of the present value of those cash flows would adjust the margin.

In general, if the margin has been exhausted and unfavourable changes have previously been recognised in profit or loss as losses, then there are two alternatives for the treatment of favourable changes related to coverage and other services in the future:

- as proposed in the ED, an entity would re-establish the margin immediately; or
- the entity would recognise favourable changes in profit or loss to the extent that they represent the reversal of losses previously recognised in profit or loss. If those favourable changes exceed the previously recognised losses, then the entity would re-establish the margin by the remainder of those changes.

Many respondents who commented on the issue disagreed with the application of the prospective approach as outlined in the ED. Many, especially regulators, believed that reinstating losses through profit or loss before rebuilding the margin would provide a more faithful representation of the margin.

What did the staff recommend?

The staff recommended that favourable changes in estimates that arise after losses have previously been recognised in profit or loss should be recognised in profit or loss to the extent that they reverse losses related to coverage and other services in the future.

The staff presented the following arguments for and against reversing previously recognised losses.

Arguments for reversing previously recognised losses	Arguments for *not* reversing previously recognised losses
Faithful representation of cumulative profit or loss If previously recognised losses are not reversed in profit or loss, then a margin could be rebuilt for a contract that is considered loss-making overall. **Consistency with IFRS** Reversing previously recognised losses in profit or loss when there are favourable assumption changes would be consistent with the requirements for: • onerous liabilities under the premium allocation approach; and • provisions and contingent liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* **Consistency of treatment between entities** Consistency between the treatment of gains and losses would improve the consistency of the amounts recognised in profit or loss between entities that report quarterly and those that report annually. It would also reduce an entity's ability to manipulate earnings by using conservative assumptions when losses are recognised and subsequently reversing those assumptions.	**Operational simplicity for preparers** Reinstating previously recognised losses would require the entity to track cumulative losses, in order to determine the losses to be reversed when there are future favourable changes in estimates. **Understandability of the financial statements** Users would need historical information about the losses to analyse the gains arising from the reversal of losses, making it difficult for users to understand the amounts recognised in profit or loss in a single reporting period.

What did the IASB decide?

The Board agreed with the staff recommendations.

KPMG insight

Entities' systems would need to continue to track and store data relating to the contractual service margin after it has been exhausted.

USING OCI TO PRESENT THE EFFECTS OF CHANGES IN DISCOUNT RATES

An entity could choose as its accounting policy to present the effects of changes in discount rates in profit or loss or in OCI and apply that accounting policy to all contracts within a portfolio, subject to the IASB staff developing further guidance.

An option for presenting the effects of changes in discount rates

What's the issue?

The ED proposed that an entity would be *required* to present the effects of changes in discount rates in OCI. This proposal was intended to increase the transparency of performance reporting by segregating in OCI the effects of changes in discount rates that are expected to unwind over time from other measurement changes.

The ED did not propose the *optional* use of OCI to present the effects of changes in discount rates because the Board believed that providing an option would:

- add additional complexity for preparers to operate the option and for users to understand the results; and
- reduce comparability and transparency between entities issuing insurance contracts.

What did the staff recommend?

The staff analysed respondents' feedback on the ED's proposed use of OCI, and believed that the Board had underestimated:

- the costs of reduced understandability resulting from accounting mismatches; and
- the benefits of reduced accounting mismatches that may result from applying an option.

As a result, the staff believed that entities should have an option to present the effects of changes in discount rates in OCI. To determine how an option could be developed appropriately, the staff reviewed existing measurement options in other IFRSs – specifically, IFRS 9 *Financial Instruments*, IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 40 *Investment Property*.

In developing an option, the staff considered the following questions.

Should there be a restriction on the use of an option?	
Options considered	**Staff's views**
• Unrestricted option: Allowing an accounting policy choice • Restricted option: Specifying criteria with a default approach	The staff supported an unrestricted option based on an entity's accounting policy choice, because this would allow entities to consider the factors contributing to their cost-benefit assessment for different types of portfolios. The staff noted that constituents' views about the most appropriate approach for different circumstances vary with their different cost-benefit assessments – i.e. balancing: • the benefits of providing information that segregates in OCI the effects of changes in discount rates; against • situations in which accounting mismatches obscure these benefits. In addition, the staff believed that: • the concerns about earnings management strategies associated with an unrestricted and revocable option would be limited by the restrictions of IAS 8, which allows a change to the accounting policy only if it would result in reliable and more relevant financial statement information; and • an irrevocable option at initial recognition may not provide relevant information if a change in asset strategies would result in significant accounting mismatches.

What should be the unit of account for the option?	
Options considered	**Staff's views**
• Entity level • Portfolio level • Contract level	The staff supported an option at the portfolio level, because they believed that: • different asset strategies for assets backing insurance liabilities are driven by differences between portfolios of insurance contracts; and • it would be consistent with many aspects of the ED that would be implemented at the portfolio level. The staff acknowledged that an option at an entity level would be the simplest approach for preparers to apply, and for users to understand. However, it may not significantly reduce accounting mismatches, because insurance liabilities are backed by a variety of assets that are measured differently. In addition, the staff noted that an option at the contract level may be the best way to eliminate accounting mismatches. However, this approach would be operationally complex and insurance contracts and related assets are typically managed at a more aggregated level.

As a result, the staff recommended that the Board confirm the use of OCI to present the effects of changes in discount rates. However, an entity would:

- choose as its accounting policy to present the effects of changes in discount rates in profit or loss or in OCI; and
- apply that accounting policy to all contracts within a portfolio.

What did the IASB discuss?

Most Board members reiterated their belief that presenting the effects of changes in discount rates in OCI provides valuable information to users of the financial statements, and therefore supported its use. However, they acknowledged constituents' concerns about accounting mismatches that may arise from the mandatory use of OCI and supported the use of an option to present the effects of changes in discount rates in OCI or in profit or loss.

Some Board members were concerned about the lack of comparability and transparency of financial statement information that may result from an unrestricted option. In response, a few members supported an irrevocable option at initial recognition. However, others opposed an irrevocable option, because it would result in accounting mismatches if the asset-liability strategy changes over time.

There was some agreement with the staff's view that IAS 8 restricts an entity's ability to change an accounting policy, but guidance would be needed on when a change in accounting policy would result in reliable and more relevant financial statement information. In addition, some Board members were concerned that the restatement of comparatives required by IAS 8 would result in additional accounting mismatches.

Some Board members also expressed concerns about the staff's recommended unit of account for the option. They believed that insurers may use small portfolios or create new portfolios every year, resulting in a free accounting policy choice for insurers and financial statement information that is not useful and comparable for users. In addition, some noted that the definition of a portfolio does not appear to be sufficiently clear in the ED and suggested a less granular unit of account – e.g. a group of portfolios, a segment level or entity level.

What did the IASB decide?

The Board decided that:

- an entity could choose as its accounting policy to present the effects of changes in discount rates in profit or loss or in OCI, and apply that accounting policy to all contracts within a portfolio, subject to the IASB staff developing guidance:
  - confirming that entities would apply the same accounting policy to groups of similar portfolios; and
  - that would provide rigour about when entities could change accounting policies based on the requirements in IAS 8; and
- if an entity chooses to present the effects of changes in discount rates in OCI, then it would recognise:
  - in profit or loss, the interest expense determined using the discount rates that applied at the date on which the contract was initially recognised; and
  - in OCI, the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the amount of the insurance contract measured using the discount rates that applied at the date on which the contract was initially recognised.

KPMG insight

The Board's decision to allow an option for presenting the effects of changes in discount rates in profit or loss or in OCI responds to the feedback on the ED's proposal for the mandatory use of OCI. Although many respondents to the ED supported the use of OCI to present the effects of changes in discount rate, many believed that it should not be mandatory but *optional*, because they are concerned about:

- accounting mismatches – e.g. if assets held to fund insurance liabilities are not classified as at fair value through OCI; and
- complexity and additional costs for preparers – e.g. to track historical discount rates and apply a large number of different yield curves to different cash flows.

An entity would disclose an analysis of total interest expense.

Disclosure of the effects of changes in discount rates

What's the issue?

If entities can select accounting policies to present the effects of changes in discount rates in profit or loss or in OCI, then it may be difficult for users to compare the effects of changes in discount rates between entities that present the amounts in profit or loss and those that present the amounts in OCI.

Depending on the accounting policy selected, different amounts would be presented in profit or loss and in OCI.

Profit or loss approach	Presented in profit or loss as a single combined interest expense.
OCI approach	Presented in: • profit or loss as interest accretion expense, using locked-in discount rates; and • OCI as the difference between: – the total interest expense in total comprehensive income; and – the interest accretion expense using locked-in discount rates.

What did the staff recommend?

The staff noted that disclosures may help to explain the effects of changes in discount rates, and to compare the performance between the two approaches.

The components of profit or loss and movements in OCI for both approaches can be illustrated as follows.[1]

Total comprehensive income	Profit or loss approach	OCI approach
Profit or loss		
• Interest accretion using locked-in discount rates		A
• Interest accretion using current discount rates	B	
• Effect of change in discount rates in the period	C	
• Difference between the measurement of amounts that adjust the contractual service margin using locked-in and current discount rates	D	
	Z	**A**
Movement in OCI		
• Interest expense using current discount rates		B
• Less: Interest accretion using locked-in discount rates		(A)
• Effect of change in discount rates in the period		C
• Difference between the measurement of amounts that adjust the contractual service margin using locked-in and current discount rates		D
		E
Total comprehensive income	**Z**	**Z**

1 This table is derived from the March staff paper 2F *Disclosure of the effect of changes in discount rates.*

The staff believed that providing an analysis of the interest expense components would provide useful information and recommended the following disclosures.

- *For all portfolios of insurance contracts:* An analysis of total interest expense included in total comprehensive income, disaggregated at a minimum into:
  - the amount of interest accretion determined using current discount rates;
  - the effects on the measurement of the insurance contract of changes in discount rates in the period; and
  - the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period measured using:
    - the discount rates that applied on initial recognition of insurance contracts; and
    - current discount rates.
- *In addition, for portfolios of insurance contracts for which the effects of changes in discount rates are presented in OCI:* An analysis of total interest expense included in total comprehensive income, disaggregated at a minimum into:
  - interest accretion at the discount rate that applied at initial recognition of the insurance contracts reported in profit or loss for the period; and
  - the movement in OCI for the period.

What did the IASB decide?

The Board agreed with the staff recommendations.

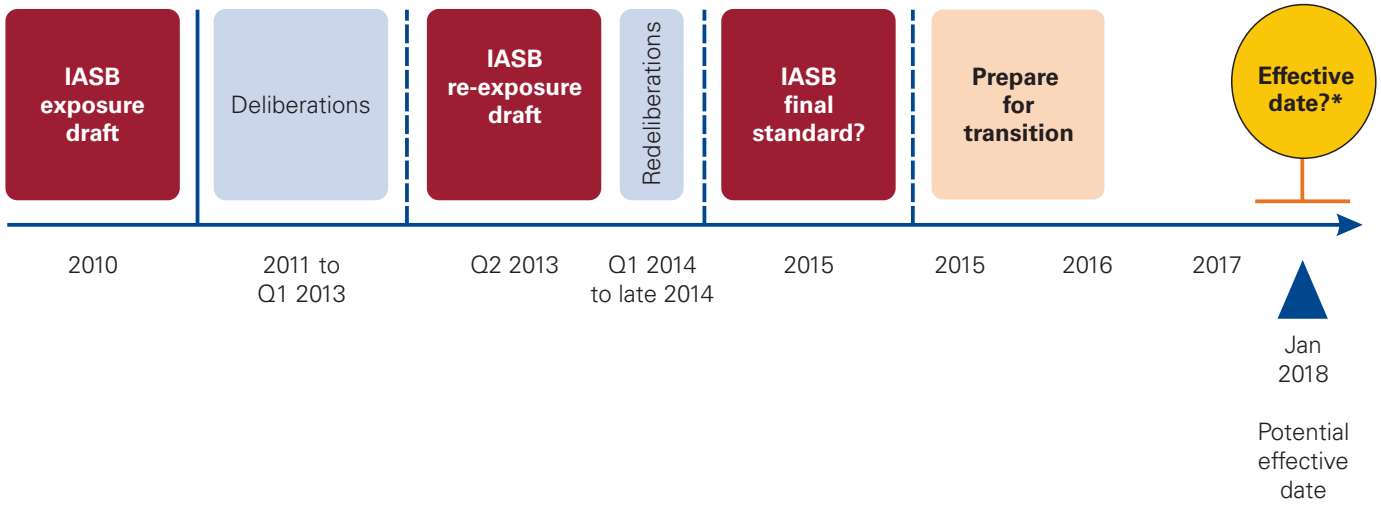
KPMG insight

The proposed disclosures of the effects of changes in discount rates may be complex.

If the final standard does not provide specific guidance on the order in which an entity calculates each component of total interest expense, then entities would have to determine a specific order and apply it consistently to all portfolios. Additionally, for entities that elect to present the effects of changes in discount rates in profit or loss, the discount rate at inception would need to be tracked.

PROJECT MILESTONES AND TIMELINE FOR COMPLETION

The IASB re-exposed its insurance contracts proposals and issued ED/2013/7 *Insurance Contracts* in June 2013. A final standard is not anticipated before early 2015.



* The effective date of the final IFRS is expected to be approximately three years after the standard is issued. The IASB staff estimates that the issue date would be in 2015 – which, on this basis, would result in an expected effective date of annual reporting periods beginning on or after 1 January 2018, if the final standard is issued in early 2015. This appears to be the Board's target, given the tentative decision that the mandatory effective date of IFRS 9 would be 1 January 2018.

Our suite of publications considers the different aspects of the project.

	KPMG publications
1	New on the Horizon: Insurance contracts (July 2013)
2	Towards the Final Frontier: Business perspectives on the insurance accounting proposals (January 2014)
3	Evolving Insurance Regulation: The kaleidoscope of change (March 2014)

For more information on the project, including our publications on the Boards' insurance proposals, see our website.

The IASB's website contains a summary of the Board's meetings, meeting materials, project summaries and status updates.

FIND OUT MORE

For more information on the insurance project, please speak to your usual KPMG contact or visit the IFRS – insurance hot topics page.

You can also go to the insurance pages on the IASB website.

Visit our Global IFRS Institute to access KPMG's most recent publications on the IASB's major projects and other activities.

Our IFRS – financial instruments hot topics page brings together our materials on the financial instruments project, including our *IFRS Newsletter: Financial Instruments*.

Our IFRS – revenue hot topics page brings together our materials on the revenue project, including our *IFRS Newsletter: Revenue*.

Our IFRS – leases hot topics page brings together our materials on the leases project, including our *IFRS Newsletter: Leases*.

Our IFRS Breaking News page brings you the latest need-to-know information on international standards in the accounting, audit and regulatory space.

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