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INSURANCE

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KPMG
cutting through complexity

"With decisions made on three of the five targeted areas and limited other issues added to the list of topics subject to redeliberation, we still expect a final standard in the first half of 2015."

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 April 2014 on its insurance contracts project.

Highlights

Insurance contract revenue

The IASB confirmed the proposals in the 2013 exposure draft for the presentation of insurance contract revenue in profit or loss and disclosures related to volume information.

Project plan for the non-targeted issues

The IASB agreed to limit discussion on non-targeted issues to seven items, with the IASB staff suggesting that only three of these issues required more analysis – portfolio definition and unit of account, discount rate for long-term contracts and unobservable market data, and asymmetrical treatment of reinsurance contracts. The staff expect the other non-targeted issues – fixed-fee service contracts, significant insurance risk guidance, recognition of contracts acquired through portfolio transfers or business combinations, and allocation pattern for the contractual service margin – to be more straightforward.

PROPOSALS FOR PRESENTING INSURANCE CONTRACT REVENUE CONFIRMED

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 2013 ED) in June 2013. The IASB is expected to complete its redeliberations of the insurance proposals in 2014 and publish a final standard in the first half of 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 2013 ED was designed to align with the IASB's and the FASB's joint proposals on revenue recognition.

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What happened in April 2014?

At its April meeting, the IASB focused on the third targeted area of the 2013 ED and discussed the proposals for insurance contract revenue.

The feedback on the 2013 ED's proposals for presenting insurance contract revenue in profit or loss was mixed and largely shaped by stakeholder-specific preferences. Although many respondents had criticised the Board's proposal for a summarised margin approach from the 2010 exposure draft (the 2010 ED), many respondents to the 2013 ED expressed concerns about whether the benefits of the insurance contract revenue proposals would outweigh the additional complexity.

At this month's meeting, the IASB confirmed its proposals for presenting insurance contract revenue and decided that an entity:

- would be prohibited from presenting premium information in profit or loss if that information is not consistent with commonly understood notions of revenue; and
- would be required to present insurance contract revenue in profit or loss, as proposed in the 2013 ED.

In addition, the IASB decided to retain the 2013 ED's disclosure proposals for volume information in the notes to the financial statements.

Although the IASB limited the questions in the 2013 ED to the key areas of significant changes from the 2010 ED, some respondents commented on other, non-targeted issues. At this month's meeting, the IASB discussed the project plan for these non-targeted issues, identifying the topics that it will discuss at future meetings.

The IASB has now redeliberated three of the five areas targeted by the 2013 ED. At future meetings, it is expected to discuss:

- the non-targeted issues;
- accounting for contracts with participating features; and
- transition.

The IASB is expected to complete its redeliberations of the insurance proposals in 2014 and publish a final standard in the first half of 2015.

INSURANCE CONTRACT REVENUE

The IASB confirmed the proposals in the 2013 ED for the presentation of insurance contract revenue in profit or loss and disclosures related to volume information.

What's the issue?

Under the 2013 ED's proposals:

- insurance contract revenue would be presented in profit or loss – i.e. insurance contract revenue would be recognised in each period as the entity satisfies the insurance contract's performance obligation;
- receipts from investment components that have not been separated from the insurance contract and accounted for under IFRS 9 *Financial Instruments* would be excluded from insurance contract revenue; and
- an entity would disclose:
  - explanations of the insurance contract revenue recognised in the period;
  - volume information, including expected premiums, related increases in obligations and expected profit; and
  - reconciliations of insurance contract balances.

Feedback on these proposals was mixed, and largely shaped by stakeholder-specific preferences. Although many respondents had criticised the IASB's proposal for a summarised margin approach from the 2010 ED, many respondents to the 2013 ED expressed concerns about the insurance contract revenue proposals, including:

- the notion of insurance contract revenue, which would be a new measure that is significantly different from the premium information that is currently presented under many local GAAPs;
- whether insurance contract revenue, as defined in the 2013 ED, provides users with the most relevant and decision-useful information; and
- the operational difficulties of excluding investment components from insurance contract revenue.

What did the staff recommend?

The staff considered the following issues.

Issues considered	Staff's views
What does insurance revenue represent?	Although the proposed measure of insurance contract revenue differs from volume information for long-duration contracts provided under existing practice, it is not a new concept. Insurance contract revenue depicts the price that the entity would charge for that period to cover the expenses for that period, the compensation the entity charged for bearing the risk in the period, plus a required profit margin. The proposals may require training for preparers and users, because the new presentation would be different from the volume information provided under existing practices. However, the new presentation would achieve consistency between revenue information for short-duration and long-duration insurance contracts, as well as non-insurance contracts measured under the revenue recognition principles.

Issues considered	Staff's views
Would users have all of the information that they need?	Currently used measures – e.g. written premiums or premiums due – were not supported because they are not consistent with commonly understood concepts of revenue and could mislead non-specialist financial statement users. Although some respondents to the 2013 ED believed that information about margins would be useful to assess the drivers of the entity's profitability, many were concerned that insurance contract revenue does not provide decision-useful information for users because it is not a measure that relates directly to cash. Under the 2013 ED, information about the following would be disclosed in the notes: • sales activities; • size and growth of business; and • changes in margins.
Would it be difficult to exclude investment components?	More meaningful information would be provided if investment components were excluded from insurance contract revenue – a view supported by feedback from users, which suggested that including investment components in insurance contract revenue may be misleading. Although excluding the investment component from insurance contract revenue may require entities to perform additional calculations and to make changes to existing systems, the staff believed that these changes would not be significantly different from other changes required to implement the new insurance standard.
Would the treatment of acquisition costs be difficult?	The proposals to allocate directly attributable acquisition costs over the coverage period in a systematic way that best reflects the transfer of services provided under the contract may add additional complexity for preparers but would avoid recognising insurance contract revenue before any coverage has been provided.
Could insurance contract revenue become negative?	At its March meeting, the Board decided that changes in the risk adjustment related to future coverage or other services would adjust the contractual service margin and would not be recognised in profit or loss. As a result, negative insurance contract revenue would be presented only in rare situations – e.g. if an entity had previously recognised insurance contract revenue for the service that it has provided but for which payment will not be received.

Additionally, the staff believed that the proposed disclosures would:

- ease the transition process by increasing the understanding of insurance contract revenue and reconciling existing and new measures; and
- respond to constituents' concerns about the loss of volume information.

As a result of its analysis, the staff recommended the Board reconfirm the proposals in the 2013 ED.

What did the IASB discuss?

In general, Board members agreed that the following may be misinterpreted or misleading to generalist users of the financial statements:

- the presentation of premium information in profit or loss that is not consistent with commonly understood notions of revenue; and
- the inclusion of a deposit component within insurance contract revenue.

The merit of an explicit prohibition on presenting premium information not consistent with commonly understood notions of revenue in profit or loss vs principles-based guidance was discussed. The nature of the prohibition would be clarified in drafting the final standard.

Example – Calculating insurance contract revenue

Insurance contract revenue could be mechanically measured using the change in the liability for the remaining coverage adjusted to eliminate changes that do not relate to the satisfaction of the performance obligation (including the part of the change that arises from losses on initial recognition or subsequent losses).

It could also be expressed as the sum of the following.

Expected claims and expenses	The latest estimates of the expected claims and expenses relating to coverage for the period, excluding those amounts recognised immediately in profit or loss and including an allocation of a portion of directly attributable acquisition costs.
Change in risk adjustment	The amount of the risk adjustment recognised in profit or loss in the period.
Release of contractual service margin	The amount of the contractual service margin recognised in profit or loss in the period.

What did the IASB decide?

The Board agreed with the staff recommendations.

KPMG insight

New performance measure

Under the revenue recognition proposals, an entity would recognise revenue when it has satisfied a performance obligation by transferring a promised good or service to a customer. Applying this notion to the insurance proposals, an entity would measure insurance contract revenue as the consideration that it is entitled to for the performance obligation satisfied in the period – i.e. the insurance coverage and other services that it has provided to the policyholder. An insurance contract would be seen to create a performance obligation that requires the entity to stand ready to pay valid claims. An entity would recognise insurance contract revenue over time, measuring it by reference to the initial estimates of the pattern of services provided for each period – e.g. by reference to the expected claims and expense in each period.

Because the proposed approach for presenting insurance contract revenue would be unlike the presentations used today, the way in which performance is communicated would be likely to change. In addition, multi-line businesses may become more complex to explain.

Non-GAAP measures may be used to explain performance, and greater emphasis may be placed on the cash flow statement, if a direct method was used.

Operational complexity

The operational complexities of the approach – i.e. to identify investment components and exclude them from insurance contract revenue and incurred claims – would introduce additional costs for preparers.

Regulations governing non-GAAP information, such as those currently being deliberated by the European Securities and Markets Authority (see our publication In the Headlines: Bridging the GAAP), may add to the cost and complexity of disclosing such measures.

PROJECT PLAN FOR NON-TARGETED ISSUES

The IASB agreed to limit discussion on non-targeted issues to seven items, with the IASB staff suggesting that only three of these issues required more analysis.

What's the issue?

The IASB received comments on the 2013 ED that were not closely related to the five targeted areas. Although the staff plan to consider drafting issues at a later stage of the project, they sought guidance at the April meeting on the project plan for non-targeted issues.

What did the staff recommend?

The staff recommended that the IASB consider the following issues in future meetings (paragraph references are to the 2013 ED).

Issue considered	Respondents' concerns
Fixed-fee service contracts (Paragraph 7(e))	Some respondents raised concerns about the scope exclusion for some fixed-fee service contracts, relating to the cost and disruption caused by changing the accounting for affected contracts for entities that treat fixed-fee service contracts as insurance contracts.
Significant insurance risk (Paragraph B19)	A few respondents were concerned that a literal interpretation of the wording of this paragraph would lead to the reclassification of a number of contracts that are widely accepted as containing significant insurance risk under the existing IFRS 4 *Insurance Contracts*. For example, these respondents asked whether the following scenario would be considered an insurance contract. • Premiums paid by a policyholder are invested in a fund. • On the policyholder's death, the beneficiary receives the greater of (a) the value of the invested fund; or (b) the value of the invested fund plus a 'top-up' to equal the total of all premiums paid.
Portfolio definition and unit of account (Appendix A)	Respondents raised concerns that the 'portfolio' definition is difficult to apply to property and casualty products in which policies contain multiple risks (e.g. physical damage, bodily injury and liability) and the pricing of the product is irrelevant to the determination of portfolios for the evaluation of the estimated claims liability (e.g. where claims reserving is performed by type of risk). They also commented that the level of aggregation required by the measurement proposals is lower than the level currently used by some entities. A lower level of aggregation is associated with higher operational costs. Although some respondents suggested that the final standard should permit entities to add contracts with a different profitability level to an existing portfolio of contracts – e.g. for contracts issued in different periods – others suggested that it should explicitly require the contractual service margin to be calculated for contracts within a portfolio by similar date of inception. Some pointed out that paragraphs 32 and B37(d) could be read as indicating that the unit of account should be set at a more detailed level than the portfolio level referred to in paragraph 28.

Issue considered	Respondents' concerns
Discount rate for long-term contracts and unobservable market data (Paragraphs B70(a) and B71)	Some respondents asked how to determine the rates used to discount long-term obligations over periods of time for which there are few or no observable market interest rates. Some proposed alternative approaches for determining discount rates, such as approaches based on average rates, historical rates, asset-based rates or proxy rates.
Asymmetrical treatment of reinsurance contracts (Paragraph 41(c))	Some respondents commented that the asymmetric treatment of the underlying insurance contract and the reinsured portion of the contract would not appropriately depict the economic relationship between the reinsurance contract and the underlying insurance contract. For example, the proposals in the 2013 ED would lead to the recognition of a loss on a direct insurance contract immediately, with any corresponding gain on a reinsurance contract being spread into future periods. Some also commented that when the cash inflows from the reinsurer exceeded the premium paid to the reinsurer – i.e. negative contractual service margin – the financial statements might not provide users with relevant information and might not faithfully represent the entity's performance.
Recognition of contracts acquired through portfolio transfer or business combination (Paragraph 46)	A few respondents sought clarification of relevant principles, specifically how to: • account for the contractual service margin recognised at the date of the business combination or portfolio transfer when the contracts assumed do not have an unexpired coverage period; and • apply the proposals to contracts accounted for using the premium-allocation approach.
Allocation pattern for the contractual service margin (Paragraph 32)	Some respondents were concerned that, without further guidance, subjectivity in determining the pattern of underlying services would result in significant diversity in the recognition of the contractual service margin in profit or loss.

The staff noted that only three of these issues were likely to require more analysis – portfolio definition and unit of account, discount rate for long-term contracts and unobservable market data, and asymmetrical treatment of reinsurance contracts. The other topics are considered by the staff to be more straightforward.

What did the IASB discuss?

There was limited discussion of other non-targeted issues that the staff recommended not be addressed at future meetings.

After more in-depth discussion, the IASB decided to retain the disclosure of a confidence level for entities that use a technique other than the confidence level technique to determine the risk adjustment. Additionally, it was agreed that the following would be considered when drafting the final standard:

- the consistency of proposals relating to ceding commissions with the final revenue standard; and
- additional guidance related to top-down and bottom-up approaches for determining discount rates.

What did the IASB decide?

The Board agreed with the staff recommendation and will consider the following non-targeted issues in future meetings.

Issues that need more analysis

- References to 'unit of account' and 'portfolio' in the 2013 ED and whether it is possible to clarify the IASB's intentions and provide more consistency.
- The possibility of providing further guidance on the discount rate for long-term contracts when there is little or no observable market data.
- Whether in some circumstances there is an accounting, rather than an economic, mismatch between insurance contracts and reinsurance contracts because of the asymmetrical treatment of their contractual service margins and, if so, whether such a mismatch could be mitigated.

Issues that are more straightforward

The IASB will decide whether to:

- provide more guidance on an appropriate allocation pattern for the contractual service margin;
- provide guidance for the significant insurance risk definition for a specific contract;
- simplify and clarify the requirements for portfolio transfers and business combinations; and
- provide an option for fixed-fee service contracts.

Issues that will not be discussed

Other non-targeted issues will *not* be considered in future meetings, including:

- disclosures;
- the premium-allocation approach;
- combining insurance contracts;
- the contract boundary for specific contracts;
- unbundling – lapse-together criteria;
- treatment of ceding commissions;
- the discount rate – top-down and bottom-up approaches;
- tax included in the measurement; and
- combining the contractual service margin with other comprehensive income (OCI).

APPENDIX: SUMMARY OF IASB'S REDELIBERATIONS

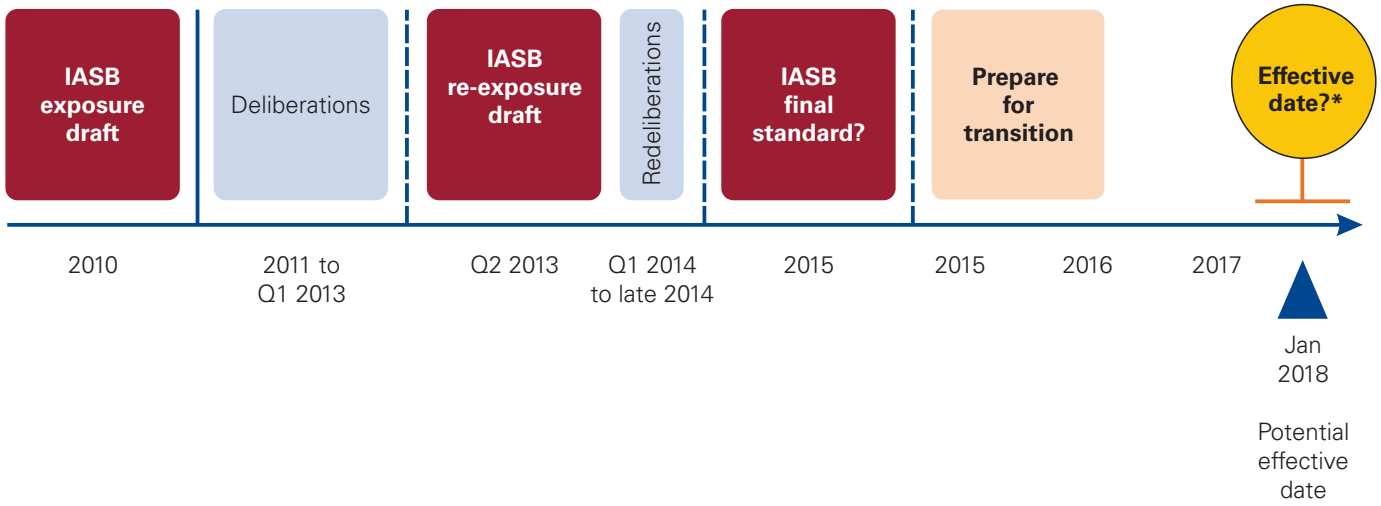
Decisions reached by the IASB during redeliberations consider only insurance contracts that have no participating features. Issues specific to participating contracts will be considered at a later stage and, at that stage, the staff will consider whether the tentative decisions reached for non-participating contracts need to be revised.

What did the IASB discuss?	What did the IASB decide?	Is there an identified change to the 2013 ED?
Unlocking 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.	Yes
	• Differences between the current and previous estimates of the risk adjustment that relate to coverage and other services for future periods would be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin would not be negative. Consequently, changes in the risk adjustment that relate to coverage and other services provided in the current and past periods would be recognised immediately in profit or loss.	Yes
Presenting the effects of changes in the discount rate in OCI	• 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*.	Yes
	• If an entity chooses to present the effect 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.	Yes
	• An entity would disclose the following information. – *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.	Yes

What did the IASB discuss?	What did the IASB decide?	Is there an identified change to the 2013 ED?
Presenting the effects of changes in the discount rate in OCI (continued)	– *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 insurance contracts reported in profit or loss for the period; and • the movement in OCI for the period.	
Insurance contract revenue	• An entity would be prohibited from presenting premium information in profit or loss if that information is not consistent with commonly understood notions of revenue. • An entity would present insurance contract revenue in profit or loss, as proposed in paragraphs 56–59 and B88–B91 of the 2013 ED. • An entity would disclose the following: – a reconciliation that separately reconciles the opening and closing balances of the components of the insurance contract asset or liability (paragraph 76 of the 2013 ED); – a reconciliation from the premiums received in the period to the insurance contract revenue in the period (paragraph 79 of the 2013 ED); – the inputs used when determining the insurance contract revenue that is recognised in the period (paragraph 81(a) of the 2013 ED); and – the effect of the insurance contracts that are initially recognised in the period on the amounts that are recognised in the statement of financial position (paragraph 81(b) of the 2013 ED).	No No No

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 expected in the first half of 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 IASB's insurance proposals, see our website. You can also find, in the same place, information about the FASB's insurance contracts project since February 2014, when this newsletter stopped following that project. For information on the FASB's project subsequent to February 2014, see our Issues & Trends in Insurance.

The IASB's website and the FASB's website contain summaries of the Boards' meetings, meeting materials, project summaries and status updates.

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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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