The Accounting and Reporting for Insurance Contracts - IASB Exposure Draft ED/2013/7
by MASB Staff (review as of 31.12.2013)

****This article will be updated from time to time to reflect IASB's latest decisions, observations and viewpoints****

<u>Background</u>

Insurance is offered and taken up by individuals or companies (the insurers) who wish to protect their financial well-being in the event of an unexpected loss by making periodic payments (premiums) to an insurance company or an entity that issues insurance contracts (the insurer).

However, accounting for these insurance contracts in the insurer's financial statements can be complex. There are diverse practices across jurisdictions, developed over the years, in absence of a Standard for insurance contracts. As a result, users of financial statements such as investors find it difficult to understand the economics of the insurance business and cannot easily ascertain the drivers of earnings and cash flows of the insurance business model.

The International Accounting Standards Board[1] (IASB) set out to develop a principle based International Financial Reporting Standard (IFRS) for insurance contracts in 1997. The project has two phases:

- Phase one was completed with the issuance of IFRS 4 *Insurance Contracts* as an interim Standard to allow insurers to continue to apply the wide variety of accounting practices and to improve the disclosures in the financial statements.

- Phase two of the project, which is currently in progress, aims to finalise a new comprehensive Standard for all types of insurance contracts to replace the IFRS 4. The phase commenced in July 2010, when the IASB published an Exposure Draft (ED) inviting global comments. However, the proposals were not widely accepted and after extensive consultations with various stakeholders in many jurisdictions, the IASB issued a revised ED in June 2013.

[1] The IASB's predecessor, the International Accounting Standards Committee carried out the initial work prior to the formation of the IASB in March 2001.

It is to be noted that, the US Financial Accounting Standards Board (FASB) and IASB work closely in joint deliberations towards the goal of developing a truly global standard for insurance contracts. However, at present, due to some differences in views, it is uncertain whether the Boards would achieve a converged Standard.

The revised Exposure Draft

The IASB proposed that the revised ED would apply to all insurance contracts, including certain financial guarantees and investment contracts with discretionary participation features. The revised ED focuses on five key areas[2]:

(A) For the statement of financial position - the measurement for insurance liabilities for long term contracts is refined as follows:
1. changes in the contractual service margin should be recognised over the remaining coverage period in a systematic way
2. long term contracts that have cash flows that are expected to vary directly with those of assets backing those contracts, must adopt the mirroring approach

(B) For the statement of comprehensive income - the presentation is to take account the proposed new Revenue[3] Standard and IFRS 9 *Financial Instruments* and adjusted as follows:
1. presentation of insurance contract revenue and expense should be consistent with the proposed Revenue Standard
2. determining interest expense for insurance liabilities with reference to IFRS 9

(C) Application of the new accounting treatment for the first time.

The revised ED has incorporated a new section on *Combination of Contracts* which is discussed in this article.

The comment period for the revised ED closed on 25 October 2013 and the MASB submitted its views through its comment letter which can be found at the MASB website at www.masb.org.my.

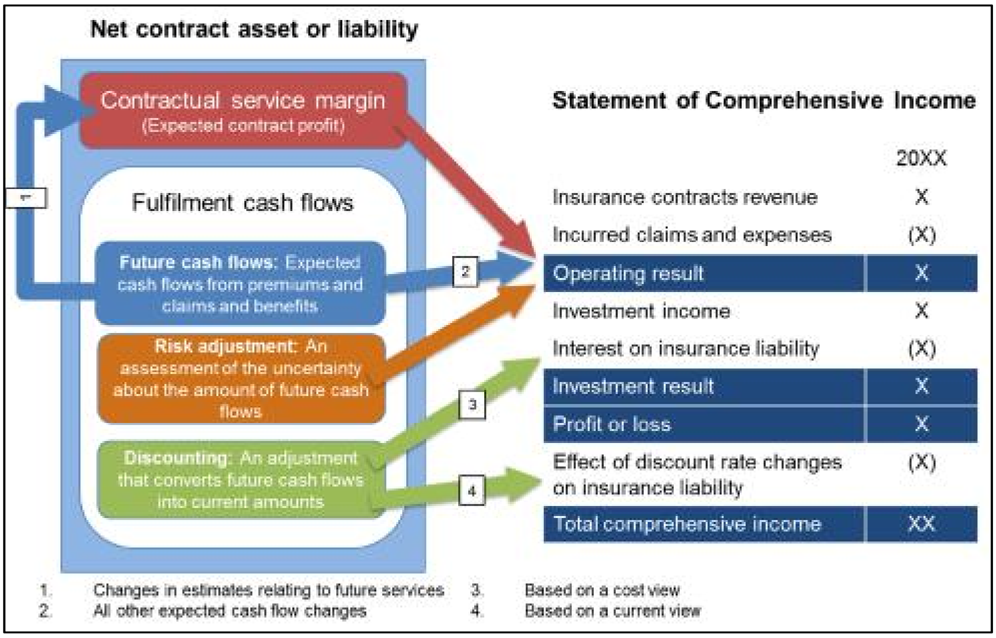
[2] The IASB's Exposure Draft 2013/07 Basis of Conclusion, Appendix A elaborates the IASB's rationale for not seeking input on other areas of the ED.

[3] In November 2013, the IASB approved the issuance of the new Revenue Standard tentatively by Q1 2014.

<u>(A) Refining the measurement approach for insurance liabilities for long term contracts</u>

<u>Proposed current measurement model for insurance liabilities for long term contracts</u>

The proposals require an entity to apply the ‘building block approach’ which comprises of the fulfilment cash flows and the contractual service margin (CSM) as illustrated below:



Fulfilment cash flows are defined as an explicit, unbiased and probability-weighted estimate (i.e. expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, adjusted for the risk of uncertainty. The cash inflows would be the premiums the insurer expects to collect while the cash outflows are the pay outs for benefits, claims and expenses relating to the contract.

The CSM represents the expected contract profit (or unearned profit) in a long term insurance contract. The CSM is to be determined at the portfolio level, as the excess of the expected present value of the cash inflows over the expected present value of future cash outflows plus the risk adjustment. The revised ED also requires the CSM to be reviewed at end of each reporting period.

This building block approach to measuring insurance liabilities will be applicable to both the life and general insurers long term policies, such as performance bonds and contractors all risk policies.

<u>(A)(1) Adjusting the contractual service margin</u>

The IASB proposes that any changes in estimation of the CSM should be recognised over the remaining coverage period in a systematic way, provided that the CSM is not negative. This basically means that the CSM should not be ‘locked in’ at inception but rather revised periodically for subsequent changes in future fulfilment cash flows. Overall, the IASB believes the proposal would reflect the economic reality of the contract and enable users of the financial statements to understand the pattern of the profit drivers.

The revised ED merely prescribes the principle that CSM changes be recognised over the remaining coverage period in a systematic way, but does not elaborate what systematic means.

Life and general insurers underwriting long term policies will need to find the right basis, and to apply this basis consistently, in recognising such CSM changes, over the remaining coverage periods.

<u>(A)(2) Long term contracts that have cash flows that are expected to vary directly with returns on underlying items</u>

The IASB proposes an exception on the building block approach of measuring insurance contract liabilities. The exception applies when the contract requires that the entity holds underlying items and specifies a link to returns on those underlying items and when there can be no economic mismatch[4] between the insurance contract and assets backing that contract. Such link has to be determined by the insurer by considering all of the substantive terms of the contract including the prevailing *laws or regulations*. This exception is called the mirroring approach.

<u>Participating policies and the mirroring approach</u>

Some insurance contracts (e.g. with-profits and unit-linked contracts) which generate cash flows that vary with the returns on underlying items are expected to meet the criteria of the mirroring approach. However, life insurers may argue whether participating contracts that allows for policyholders to share profits in a general or specific portfolio albeit at the discretion of the insurer, meets the criteria.

In participating policies, the investment returns assumption carries a higher weightage than other operating assumptions. Therefore the investment asset allocation is expected to generate the returns (and contribute to profits) although policyholders are not informed of the details of such asset allocations. But, there is a reasonable expectation of such participating policyholders that profits would be distributed over the life of their participating policies. Consequently, the link between the payments to the policyholder and the returns on those underlying items for a participating portfolio may not be entirely clear.

Recent discussions including those with IASB, appear to indicate that the liabilities of participating policies may be measured by the building block approach.

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[4] The IASB’s Exposure Draft 2013/07 Basis of Conclusion, BC 45 states that economic mismatches arise if the value of, or cash flows from, related assets and liabilities respond differently to changes in economic conditions.

Measuring the insurance liabilities for short term contracts

The current practices of measurement of premium and claims liabilities remain intact except that for long tail claims liabilities, these are further requirements,

- Discounting IBNRs (Incurred But Not Reported) to present value
- Reporting unwinding of the discount rate as interest expense in the profit or loss statement
- Reporting the effect of changes in discount rates in other comprehensive income (OCI)

(B) Aligning the presentation to take into account the proposed new Revenue Standard and IFRS 9

(B)(1) Presentation of insurance contract revenue and expense

The suggested presentation for long term and short term insurance contracts in the statement of comprehensive income is as follows:

Long term contracts (Building blocks approach)	**20xx**
Insurance contracts revenue	x
Incurred claims and expenses	(x)
Operating result	**x**
Investment income	x
Interest expense on insurance liability (unwinding effect)	(x)
Profit or loss	**x**
Effect of discount rate changes (in OCI)	(x)
Total comprehensive income	**xx**

Short term contracts (Premium allocation approach)	**20xx**
Gross earned premiums	x
Premiums ceded to reinsurers	(x)
Net earned premiums	**x**
Incurred claims and expenses	(x)
Underwriting result	**x**
Investment income	(x)
Interest expense on long tail claims liability (unwinding effect)	(x)
Profit or loss	**x**
Effect of discount rate changes (in OCI)	**(x)**
Total comprehensive income	**xx**

Consistent with the proposed new Revenue Standard, the insurance contract revenue represents the consideration for:

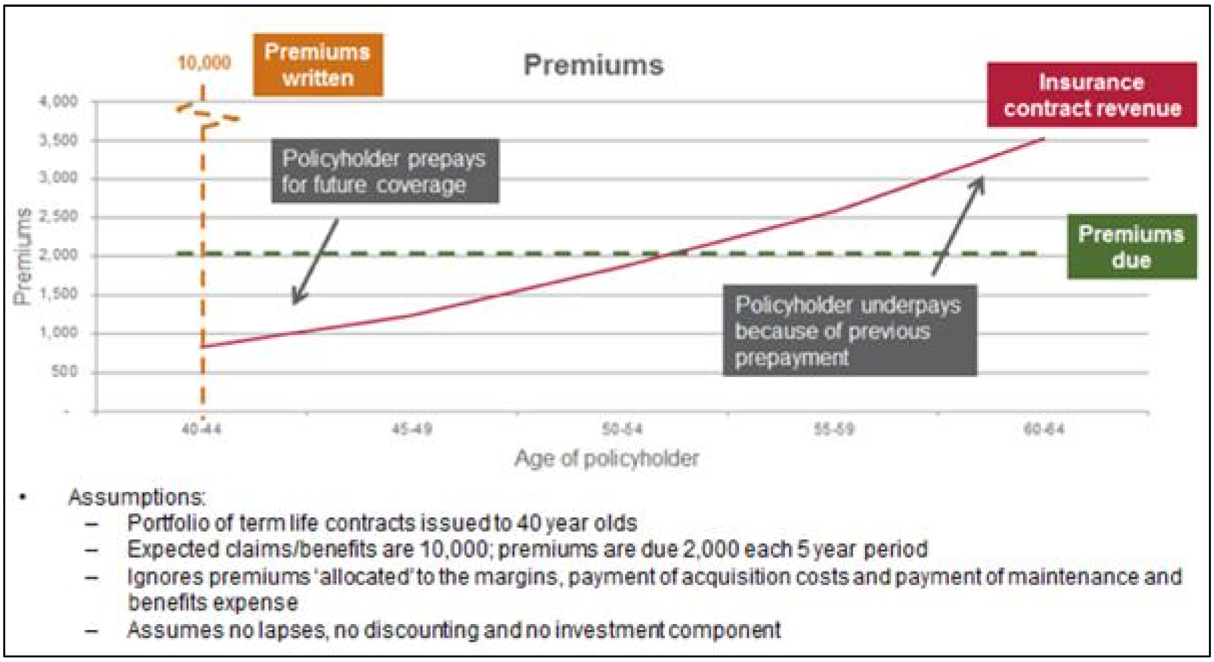
- Providing insurance coverage;
- Bearing risk in the coverage period; and
- Paying expected claims and benefits.

Accordingly, the long term insurance contract revenue would consist of the risk bearing earned premiums, expected claims, changes in risk adjustments and release of CSM for the financial period under review. Premiums paid by the policy holders which are distinct for investment purposes (and not highly interrelated to insurance) are unbundled, and considered as deposits. Investment premium refunds and benefit payments unrelated to an insurance event will be treated as deposits repayment.

Hence, life insurers will have to assess the impact on their top line, given the definition in the proposed new Revenue Standard.

General insurers underwriting long term contracts will also have 2 types of presentations; the premium allocation method for short term contracts such as motor policies and the building block approach for long term contracts such as performance bonds and contractors all risk policies.

The diagram[5] below illustrates the revenue trend line for a term life insurance:



[5] Extracted from IASB Staff slides 'Overview of accounting proposals for insurance contracts' dated June 2013.

(B)(2) Determining interest expense and discount rate changes through OCI

The main reason for recording the effect of discount rate changes through OCI is to prevent the distortion and undue fluctuations of the underwriting performance.

An overview of the proposal is shown below.

Statement of Comprehensive Income	20xx
Underwriting result	**x**
Investment income	x
Interest expense on insurance liability	(x)
Investment result	x
Profit or loss	**x**
Effect of discount rate changes through OCI	(x)
Total comprehensive income	**xx**

Profit or loss

Reflects the profit or loss from services using an amortised cost* view of the time value of money. Captures the unwinding of discount rate which was applied at inception.

Total comprehensive income

Reflects the profit or loss of providing services using a current view of the time value of money**

** the amortised cost view uses the discount rate determined at contract inception, and current view uses the current discount rate at reporting date*
*** the 'effect of discount rate changes' reconciles the current view and the amortised cost view of performance, assuming financial assets are measured at fair value through OCI*

There are mixed views whether discount rate changes should flow through OCI as some constituents prefer the changes to flow through the profit and loss account. IASB's final decision would be dependent on the final proposals of the IFRS 9.

(C) Applying the new accounting for the first time

Life and general insurers underwriting long term contracts, and applying this new Standard for the first time, will have to ascertain the CSM of existing contracts. This is to ensure appropriate accountability and comparability between contracts in force at first adoption of the Standard and subsequent contracts underwritten.

The tentative IASB timetable (as at November 2013) targets the issuance of the Standard in early 2015, after further deliberations in 2014. The date of mandatory application would be at least 3 years from the date of issuance of the Standard, with an option for early adoption. There are requests to the IASB to synchronise the issuance of the Standard and IFRS 9 for application by the Insurance Industry.

Combination of insurance contracts

The proposed new Revenue Standard requires an entity to combine two or more contracts as a single contract if they are negotiated as a package with a single commercial objective and if the amount of consideration to be paid in one contract depends on the price or performance of the other contract. The IASB's view is that the combination principle would apply equally to insurance contracts. The discussion on combination of insurance contracts is given in paragraph 8 of the revised ED.

Insurers will have to take cognizance of this principle and assess whether there are situations where they have to combine contracts and account for such combinations accordingly.

Next steps for the insurance industry and entities issuing insurance contracts

It is important for insurers and entities who issue insurance contracts, to assess early the impact of the revised ED to their businesses. For insurance companies, the Standard, upon its issuance, would accentuate the interrelatedness of three critical functions, i.e. finance, actuarial and investment, hence, their need to work closely together. An implementation plan to prepare for the adoption of the Standard is crucial. The preparations could include reviewing, enhancing and interfacing actuarial applications to the core financial systems; training personnel from the abovementioned 3 functional areas on the requirements of the Standard; and educating the Board of Directors and Audit Committees accordingly, before its adoption.