Update on IASB insurance accounting project

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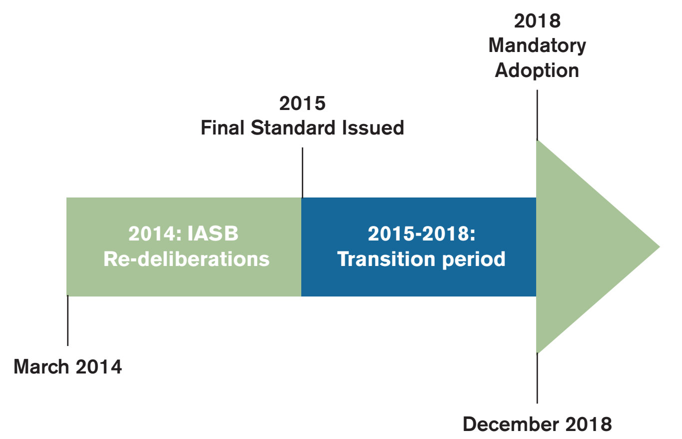
The IASB has made several tentative decisions in its insurance accounting project based on discussions of the feedback received on its 2013 exposure draft (ED). The Board received 194 comment letters and conducted 187 outreach meetings. The Board discussed the comment letters in January and since March has been re-deliberating several key issues.

BACKGROUND

The 2013 exposure draft (ED) was the latest document issued during the long-running project of the International Accounting Standards Board (IASB) on accounting for insurance contracts. The 2013 ED was a limited scope follow-up to the IASB's full scope 2010 ED. The proposals contained in the EDs are intended to replace the current standard, International Financial Reporting Standard (IFRS) 4: Insurance Contracts. The consultation on the 2013 ED, which ended in October 2013, asked for feedback on a limited number of areas where the Board's proposals have significantly changed since their 2010 ED. In addition, the IASB requested feedback on the likely costs of implementing the proposals.

The IASB's current timeline suggests that a final standard could be issued in 2015 and, given that the IASB has agreed to a three-year period between final standard and mandatory adoption, implementation is likely to happen no earlier than year-end 2018.

FIGURE 1: LATEST TIMELINE



FEEDBACK REQUESTED IN FIVE AREAS

The IASB asked for feedback in five areas where its proposal had changed significantly from the 2010 ED: 1) unlocking of margins, 2) measuring participating features and in particular the proposed mirroring approach, 3) use of Other Comprehensive Income (OCI), 4) definition of revenue, and 5) transition. Respondents also provided comments in other areas of the proposed accounting model and the IASB is considering some of that feedback as well. In the sections that follow we summarize the IASB's re-deliberations on these topics to date and its tentative decisions.

UNLOCKING FOR CHANGES IN ESTIMATES

The reserve method proposed by the IASB includes three main components: an expected present value (PV) of future cash flows, a margin for the risk of deviation in the underlying cash flows, and a contractual service margin (CSM) that represents the present value of earnings expected to be earned for providing future insurance services. The question the IASB is attempting to answer is: to the extent estimates of future experience change and those changes affect the amount of profit an entity expects to earn in the future on that contract, should the impact of the change affect the margin that represents the expected earnings for providing future services or directly affect the profit and loss statement (P&L)?

The IASB has tentatively decided to unlock the CSM for changes in estimates that relate to futures services and for changes in the risk adjustment. Once the CSM is depleted, the impact of further adverse changes must be immediately recognized in profit and loss. The IASB has also tentatively decided that losses previously recognized because of changes in estimates are reversed first before a margin is rebuilt. In other words, if previous changes in estimates had caused the CSM to be unlocked to the point it was reduced to zero (no expected future profit) and then subsequent to that estimates changed so that some amount of future profit was again expected, the margin established currently would need to reverse any hypothetical negative margin that might have been determined from prior periods before reestablishing a positive CSM. For example, assume the CSM prior to unlocking was 10 and estimates changed such that the PV of future profits would be reduced by 12. In theory, unlocking would reduce the CSM to -2 (10 - 12), but the CSM is floored at zero. Assume that in the next period estimates of future cash flows change such that the PV of future profits increased by 5. The IASB has decided that, when unlocking the CSM in this period, the starting point should be the hypothetical -2, which results in a profit of 2 and a margin of 3 (-2 + 5) rather than starting with the reported CSM of zero, which would result in a margin of 5 (0 + 5). This means that entities will need to track the hypothetical margin as well as the reported margin for each cohort.

The IASB has yet to determine how unlocking of the CSM will interact with the use of OCI and how the unlocking will work with contracts containing participation features.

MEASURING PARTICIPATING FEATURES

Participation features typically allow for payments to policyholders that are based in some way on the performance of an underlying asset or block of business. There is a wide variety of payment schemes in use, varying in the amount and timing of those payments, the amount of insurer discretion involved, and the source of profits that inure to the insurer. Contracts with participation features often contain embedded options and guarantees.

2013 ED proposal of mirroring

The 2013 ED proposed that, for participation features where there was no possibility of economic mismatch, i.e., that payments to the policyholder must vary directly with the returns on the underlying items and the entity is required to hold the underlying items, the entity could measure the value of the participation feature at the value of the underlying item. Effectively the measurement of the feature mirrors the value of the underlying item. While there was general support for the concept there were several concerns expressed by respondents. For many contracts the expected cash flows would need to be bifurcated into participating and nonparticipating elements and subjected to separate measurement, significantly increasing the complexity of the valuation. Further, it is unclear how unlocking of the margin would interact with the mirroring approach and how widely or narrowly the proposal would apply.

IASB re-deliberation

The Board is reconsidering whether it might be possible to adapt the general measurement proposals to apply to participation features instead of providing an exception that requires a different measurement model. The Board and staff have identified six key issues they feel need to be addressed. They are:

1. Can measurement of insurance contracts be achieved without bifurcation of cash flows?

2. Should changes in estimates of the insurer's share of underlying items adjust the CSM?

3. Where should changes in estimates of future cash flows arising from changes in estimates of investment returns be recognized?

4. How should the CSM be recognized in P&L when asset management services are provided?

5. Where should changes in estimates of embedded options and guarantees be recognized?

6. Are there any contracts with participation features for which an OCI approach provides useful information? If so, how should interest expense in P&L be determined?

The Board plans to make decisions about the accounting for contracts with participation features as a whole at a future meeting. In the meantime it has directed the staff to consider certain elements of an alternative measurement approach where implicit asset management fees are considered and where a book yield approach might be considered.

CONTRACT REVENUE

The IASB has effectively reaffirmed its proposal that contract revenue and expense presented in the statement of comprehensive income exclude investment components and recognize revenue as it is earned. The IASB also intends to require disclosure of the following:

- Reconciliation of revenue to premiums received

- Inputs used to determine insurance contract revenue

- Effect of insurance contracts initially recognized in the period on amounts recognized in statement of financial position

OTHER COMPREHENSIVE INCOME

The IASB has tentatively decided to allow companies to present the effect of changes in discount rates in OCI on an optional basis. Similar insurance contracts would need to be treated similarly with regards to presentation in OCI. The Board would require disclosure of the component parts of the change in interest expense that would allow for comparison between entities. The Board intends to further discuss when an entity can change its accounting policy to switch to using or not using OCI. As noted earlier the Board is still to discuss how unlocking of the CSM will interact with the use of OCI presentation of the impact of changes in discount rates and the application of OCI presentation for participating features.

TRANSITION

The IASB has not yet reconsidered any transition issues. It plans to do so once it has a near-final model.

OTHER ISSUES

The IASB has discussed several other issues on which it did not request specific feedback. A summary of three key items discussed follows.

Allocation of CSM

The IASB has refined its proposal regarding how the provision of insurance service is to be measured for purposes of releasing the CSM. It has determined that it should be based on the passage of time and reflect the expected number of contracts. Insurers will not be able to use alternative measures of how it might be reviewed from risk on the underlying contracts.

Portfolio transfers

The Board clarified that contracts acquired through portfolio transfers and business combinations should be accounted for as if they had been issued by the reporting entity at the acquisition date.

Level of aggregation and the definition of portfolio

The Board intends to provide clarifying guidance that the objective is to measure a single insurance contract and provide examples on the extent to which an entity can aggregate contracts and still meet the objective.

CONCLUSION

Several key tentative decisions have been made by the IASB that materially alter the proposals contained in its 2013 ED. While some key issues have yet to be decided, including the important topic of measuring participation features, the Board is moving quickly in its deliberations and expects to issue a final standard in 2015.

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