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Insurance Accounting Newsletter
The IASB completes its decisions on how to account for all non-participating insurance contracts

Focus on non-participating contracts

The redeliberation process following the end of the comment period on the draft IFRS *Insurance Contracts* on 25 October 2013 (the 2013 ED) is a story of two differently paced decision making activities at the International Accounting Standard Board (IASB or the Board). One activity was carried out at pace that has been sustained throughout 2014 (see Insurance Accounting Newsletter issue 30 for additional details[1]) and that focussed on the new accounting model for non-participating insurance contracts. This activity can be considered substantially complete at the time of writing.

The other activity has been causing a delay on the original IASB work plan to complete the redeliberations during 2014, as after several educational sessions (including one in 2015) this has yet to enter the decision making stage. This is the debate on the accounting for contracts with participation features.

Given this, the current issue of the Insurance Accounting Newsletter is dedicated to the analysis of the decisions that have completed the accounting model for non-participating contracts. The next issue will be released shortly, and this will contain the analysis of the key issues that the IASB has been debating over the past several months with an extensive commentary on each of those taken from the Deloitte comment letter to the 2013 ED.

We believe that Deloitte recommendations on the accounting for participating contracts remain particularly valid at this juncture and the next issue in our series will set them out against our understanding of the current IASB debate..

The IASB has reached tentative decisions on several issues all of which relate only to non-participating insurance contracts. The IASB has indicated that they will revisit these decisions after it has completed its re-deliberations on participating contracts. In addition, these decisions will act as important precedents against which we believe the IASB will take its last round of decisions.

The areas where the IASB deliberated non-participating contracts are:

- principles for the allocation to profit or loss of the Contractual Service Margin (CSM);
- scope exclusion for fixed fee service contracts;
- refinement of the definition of what represents significant insurance risk for contract classification purposes;
- the treatment of gains and losses on the recognition of portfolio transfers and business combinations;
- application guidance for determining discount rates when there is lack of observable data;

1 Download Deloitte Insurance Accounting Newsletter, issue 30 at www.deloitte.com/i2ii

- the treatment of asymmetrical gains and losses from purchased reinsurance contracts;
- the level of aggregation to use (a) when measuring an insurance contract; and (b) in respect of the definition of a portfolio;
- the rate to accrete interest expense on the CSM balance and to discount the cash flows that unlock the CSM;
- guidance for a change in accounting policy that introduces or removes the OCI solution for a portfolio;
- revenue recognition principles when the Premium Allocation Approach (PAA) is elected;
- determining the discount rate for claims incurred liabilities;
- introduction of a modification to the restatement of the risk adjustment balance when the insurer uses the simplified restatement approach; and
- creating a fair value restatement approach for contracts where both the full restatement and the simplified restatement approaches are impracticable.

Following its decision to extend the period for the completion of the re-deliberation on the IFRS on insurance contracts, the IASB met in January 2015 to discuss transition arrangement arising from the implementation of IFRS 9 Financial Instruments at a date that will now be earlier than the implementation of the new IFRS for insurance contracts.

The IASB meeting in February 2015 continued the discussion on contracts with participating features. As this was an education session, no decisions were taken and the discussion was restricted to the sole issue of contract aggregation where the approach taken for non-participating contracts has been considered against the characteristics of contracts with participation features.

Complete set of decisions for non-participating insurance contracts

As explained above, the IASB has effectively completed its decision making activity on all the areas it had planned to deliberate outside the targeted areas included in the 2013 ED and, as far as non-participating contracts are concerned, also on four of the five targeted areas set out in the 2013 ED. The only targeted area yet to be re-deliberated is the accounting for participating contracts itself.

Our analysis below explains all of the non-participating contracts decisions in detail and in chronological order.[2]

Recognising the contractual service margin in profit or loss (decided at the May 2014 IASB meeting)

Comments on the 2013 ED raised concerns over the lack of sufficient guidance on how an insurer should determine the pattern of release through profit or loss of the CSM for a portfolio of contracts. In response, the Board tentatively decided to approve the Staff recommendation to:

- confirm the principle that an insurer should recognise the remaining CSM in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract; and
- clarify that, for non-participating contracts, the service represented by the CSM is the insurance coverage which:
  - Is provided on the basis of the passage of time; and
  - Reflects the expected number of contracts in force.

The Board discussed whether the incidence of claims should also be a consideration where the expected claims were unlikely to be spread evenly over the duration of the contracts, for example for weather related covers. However, in many long term contracts the pattern of claims is non-linear over time (e.g. a portfolio of insurance contracts that covers the risk of death over a long period of time have the claims pattern skewed towards the end of the expected coverage period i.e. when the expected death claims would be payable) thus the use of a claims incidence factor is likely to produce a less faithful presentation of the service delivered in the earlier years of these contracts when it could be validly argued that the "stand ready" service provided is identical to that rendered in the later years.

The Staff commented that to release the CSM based on the occurrence of claims would often result in back end loading for the recognition of a contract profit because little CSM would be released until the claim has occurred. Such a method would not reflect the fact that the service of standing ready to accept a claim is being provided over time, irrespective of the claim occurring. Additionally, using the pattern of claims would make the model more complex.

Although there was considerable support for taking expected claims into account, the Board members supported the Staff's recommendation on cost-benefit grounds.

2 Download Deloitte Project Insight – Insurance Contracts at www.deloitte.com/i2ii for a complete picture of all the IASB decisions to date.

Whilst the CSM release for an individual policy would be linear, subject to a full release on contract termination, this decision will result in the pattern of CSM release for a portfolio being non-linear, resulting in a blended rate that combines the passage of time (linear release) with expected lapses, deaths and maturities, both from the number of contracts and the CSM absolute value perspective (non-linear release).

The Staff clarified that the CSM value should be taken into account in determining the pattern of release of the CSM for a portfolio of contracts but that this would be discussed in a future IASB meeting (please refer to the 'Level of Aggregation' section of this newsletter as decided during the June 2014 IASB meeting).

Therefore, taking into consideration the unit of account for releasing the CSM, the release pattern for a portfolio of contracts would thus consider three dimensions: the remaining expected coverage period, the absolute monetary value of CSM for individual contracts and the number of contracts in force. The estimate of these three dimensions will depend on the term of the policy, the expected lapse/death/maturity rate and the period of inception of the policy which resulted in the initial recognition of the CSM and started its release through profit or loss.

The Board did not elaborate this guidance further, but it would appear that the determination of the pattern of release for a portfolio would require greater granularity within the portfolio to establish groups of contracts within the portfolio with similar features to enable the application of this clarified guidance. This approach is similar to the notion of creating 'CSM cohorts' within a portfolio for the purpose of releasing the CSM through profit or loss.

In the Deloitte response to the 2013 ED we suggested introducing the definition of cohorts and that the unlocking of the CSM should be carried out at a portfolio level with the unlocking adjustment allocated to each cohort proportionally.

The Deloitte position on the CSM pattern of release

Extract from 2013 revised ED Comment letter:

"We recommend that a new definition is introduced in Appendix A to capture the key concept set out in paragraph 32 for the subsequent measurement of the CSM:

Release pattern of the CSM: *the systematic way that best reflects the remaining transfer of services that are provided under the contract*

We recommend that the CSM is recognised within a portfolio by grouping contracts that belong to that portfolio and that have been issued within the same annual financial period (or a shorter period within that annual period) which present similar or not materially different expected durations (a necessary common characteristic to apply the requirement of paragraph 32 as amended based on our recommendation from our response to Question 1) and a similar "release pattern".

We recommend that the group of contracts described above is defined as a CSM cohort and that the following definition is added to Appendix A:

CSM cohort: *the CSM attributable to a group of contracts that have been issued within the same annual financial period (or a shorter period within that annual period), that present similar or not materially different expected durations and that will use a similar release pattern*

We recommend that the final IFRS should explain that the unlocking of the CSM is carried out at a portfolio level and that on unlocking the adjustment to the portfolio CSM should be allocated to each cohort in that portfolio proportionally. This can be allocated, for example, in proportion to the level of each of the cohorts' CSMs outstanding at the beginning of the period or in proportion to the level of each cohort's expected future cash outflows. The allocation basis ultimately needs to be consistent with the release of the CSM to profit and loss at the cohort level."

Scope decision on fixed fee service contracts (decided at the May 2014 IASB meeting)

The 2013 ED scoped-out certain fixed-fee contracts that are currently accounted for as insurance under IFRS 4 *Insurance Contracts.* This proposal prompted cost-benefit concerns from some preparers and as a result it was suggested that an option to account for such contracts as insurance should be introduced. The Board tentatively decided to permit, but not to require, entities to apply IFRS 15 *Revenue recognition* to those fixed-fee service contracts that meet the criteria to be accounted for as insurance contracts.

This election would need to be made at an entity level rather than at the portfolio level.

There was a general discussion of the limited desirability of introducing options into new IFRSs. However, the Staff representation that there would not be much difference in practice between applying either IFRS 15 or the new IFRS on insurance contracts to fixed-fee service contracts persuaded the Board to approve the replacement of the scope exclusion with an accounting policy option that seems to leave comparability unaffected.

Deloitte position on fixed fee contracts scope exclusion

Extract from DTTL Comment Letter on the 2010 ED:

"We do not agree with the proposed amendment to the scope exclusions in paragraph 4 that proposes to scope out fixed fee service contracts. This scope exclusion is not well defined and it could result in less relevant information than if these contracts were in the scope of the final IFRS."

The IASB decision has substantially moved their position towards Deloitte's recommendation. Comments observed during the IASB meeting suggest that the benefits of this scope exclusion were already deemed of limited magnitude. The dilution of the 2013 proposal seems to produce little changes from the accounting for these contracts that would have been required if such scope exclusion had not been introduced altogether.

Refinement of the definition of significant insurance risk (decided at the May 2014 IASB meeting)

The Board confirmed that it would like to retain the clarification of the guidance published in the 2013 ED on the definition of significant insurance risk. Accordingly, significant insurance risk occurs only when there is a possibility that an insurer incurs a loss on a present value basis. This has been consistent with our understanding of the practical application of the classification principles already contained in IFRS 4 and the additional guidance merely clarifies an established practice.

Gains and losses from the recognition of insurance contracts acquired via portfolio transfers and business combinations (decided at the May 2014 IASB meeting)

After discussion the Board voted in favour of amending the requirements for the contracts acquired through a portfolio transfer or a business combination. The amendment clarifies that such contracts should be accounted for as if they had been issued by the acquiring entity at the date of the portfolio transfer or the business combination irrespective of whether the acquired contracts do or do not have unexpired coverage at the acquisition date.

The need for this new decision arises in relation to the recognition of profit for contracts with expired coverage. If the CSM has to be released based on coverage, then initial recognition of such contracts when acquired by another entity would result in a gain on initial recognition.

With this new decision the CSM would be recognised in profit or loss over the period of claims handling when the acquired contracts have no residual coverage. The Staff will develop some further guidance to implement this decision which introduces a direct departure from the general principle that CSM is earned and released over the coverage period, being the period over which the relevant services are provided to the policyholder.

The Board has consistently rejected the views from some respondents (including Deloitte) that the claims-handling period is also a period of provision of relevant services to the policyholder.

The 2013 ED had also clarified that for purchased reinsurance contracts reinsuring insurance policies with expired coverage (for example retrospective reinsurance) the cedant must recognise a CSM balance (the CSM being a credit balance that eliminates the accounting gain) reducing the reinsurance asset when the net present value of cash flows from the purchased reinsurance contract is positive. This CSM is earned over the claims handling period derived from the underlying reinsured contract.

Deloitte position on the CSM earning period

Extract from 2013 ED Comment Letter

"We continue to believe that the proposal in the 2013 ED to release the CSM over the coverage period establishes an inappropriate dividing line given that the insurer's contractual obligations are not interrupted by the expiry of the coverage period. In our opinion the CSM should be released based on the pattern of transfer of services under the contract (or release from risk), consistent with the Board's proposal but without the time restrictions for claims handling periods set in paragraphs 32 and B68(a)."

Determining the discount rate when there is a lack of observable data (decided at the June 2014 IASB meeting)

The 2013 ED has established the key principle that the discount rate to be applied to the insurance cash flows should be referenced to appropriate assets which have similar characteristics to the underlying insurance contracts. The discount rate curve should be current, market consistent and inclusive of any premium reflecting the liquidity characteristics of that insurance contract.

It was recognised that comments from many respondents from the 2013 ED highlighted certain practical difficulties in extrapolating an observable yield curve. These difficulties are caused by the lack of assets which have the same duration period as the underlying long term insurance contracts. Furthermore, the introduction of the top-down or bottom-up approaches, also articulated in the 2013 ED, to determine the appropriate discount rate, clarified the need for an illiquidity premium to reflect the lack of a liquid and active market for insurance contracts and therefore reflect the fact that the costs of exiting an insurance contract are more significant than those of a financial instrument. However, without any significant practical guidance offered by the IASB in determining the appropriate illiquidity premium and given that market practices vary in the techniques employed to determine this premium, the Staff felt it would be appropriate to provide further clarity in the final IFRS.

As proposed in the 2013 ED, if insurers simply used observable rates with no adjustments, there would be significant market volatility caused by using observable shorter duration rates to discount the longer term cash flows estimates.

The Staff commented that in practice an insurer may use its judgment to adjust market interest rates for the timing difference between the cash flows of the referenced asset portfolio and the timing of the cash flows of the insurance contracts. The insurer may also need to adjust the observable interest rates for the credit risk and liquidity risk of the referenced asset portfolio when these are not consistent with the insurance cash flows.

The measurement approach for determining the discount rate in the 2013 ED and the fair value measurement approach as outlined under IFRS 13 *Fair value measurement* when measuring the fair value of a liability for which there is no available quoted price, have a consistent principle when placing reliance on use of valuation techniques. This principle requires the entity to maximise the use of observable market information in judging the appropriate adjustments to determine the value of a liability which is not quoted on an active market or actively traded.

In particular, applying the IFRS 13 principles and the fair value hierarchy for insurance contracts would result in employing techniques consistent with the fair valuation of non-actively traded assets or liabilities where the discount rate is set on the assumptions that a market participant would use when determining the appropriate fair value. This requires an entity to estimate market participants' assumptions in determining the fair value of that asset or liability.

The Staff proposed to the Board the following amendments and additional guidance to set the appropriate discount rates for insurance contracts:

- ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured; and

- develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly, any unobservable inputs should not contradict any available and relevant market data.

In addition, the Staff proposed amendments to clarify that the discount rates should reflect the illiquidity characteristics of the contract but would exclude the effect of the entity's own non-performance (i.e. own credit risk) and that discount rates applied to asset dependent cash flows within the insurance contract, should be used to reflect that dependency.

The Board supported the additional guidance and requested that a statement is added to the final text to explain that the measurement principles of each of the building blocks must maximise the use of observable data and minimise the use of non-observable data. The reason for one IASB member's support was that whilst the IASB was not proposing the fair value measurement for insurance contracts, many of the principles within IFRS 13 are relevant in the determination of the discount rate and therefore they should be appropriately incorporated in the final IFRS for insurance contracts.

Asymmetrical treatment of gains from purchased reinsurance contracts (decided at the June 2014 IASB meeting)

The Staff proposed modifications to the treatment of asymmetrical gains arising from reinsurance contracts purchased and the underlying direct insurance contracts following comments received on the 2013 ED. The comment letters recommended that the IASB should make an exception to the building blocks principles for the CSM associated with a purchased reinsurance contract such that a cedant is required to adjust the CSM of the reinsurance asset when the underlying insurance contracts have become onerous and therefore a deficit is immediately recognised in profit or loss. Without a release of the CSM from the reinsurance asset in the same reporting period the cedant would be forced to report an accounting mismatch.

Under the building blocks approach a portfolio is onerous when the expected present value of cash outflows exceeds the expected present value of cash inflows, after allowing for risk, resulting in a negative CSM, which must be immediately expensed to profit or loss.

For a reinsurance contract purchased by an entity which applies the building blocks approach the cash outflows would represent the premiums paid to the reinsurer and the cash inflows would represent the expected recoveries. When a net loss arises at inception of a portfolio of sold reinsurance contracts it would be recognised as a day one loss while a cedant would book a CSM "asset" and amortise it over the coverage/service period of that purchased reinsurance contract. When the cash inflows the cedant expects exceed the cash outflows of a purchased reinsurance contract, the cedant would recognise a CSM "liability" that would reduce the reinsurance assets and would then be recognised as income in profit or loss over the coverage/service period of the reinsurance contract.

The Staff confirmed that the underlying direct insurance contracts and the purchased reinsurance contracts are separate contracts and should be recognised separately on initial recognition.

The Staff proposed that separate consideration should be applied on subsequent measurement where changes in the cash outflows on the underlying reinsured contracts that impact the cash inflows from the associated purchased reinsurance contract should have a neutral impact on the net result for the period. Therefore in the event the reinsured insurance contracts become onerous, the impact to the change in estimates for the corresponding reinsurance cash flows would also be recognised within the profit or loss to avoid an accounting mismatch.

This proposal would also apply to those reinsurance contracts which use the PAA whereby if a contract becomes onerous, an additional liability is recognised with the change in the reinsurance asset being recognised in the profit or loss to mirror the change in the reinsured contracts.

The Board voted in favour of these recommendations.

Level of aggregation (decided at the June 2014 IASB meeting)

As mentioned in issue 30 of our Insurance Accounting Newsletter, the IASB received a number of comments on the different levels of aggregation used throughout the 2013 ED. This was causing some confusion and respondents asked for more clarity, particularly in relation to the level of aggregation required for the initial and subsequent measurement of the CSM. In response, the Staff developed a proposal to clarify the overall measurement objective and measurement principles.

The Board voted that the measurement objective of the new IFRS is to provide principles for the measurement of an individual insurance contract. An entity can aggregate insurance contracts, provided that it does so in a way that meets that objective. During the discussion it was clarified that in measuring an insurance contract for certain estimates it is appropriate to use a portfolio basis to reflect the pooling of risks concept, but other estimates are contract-specific and should not be averaged across a portfolio.

For example, the estimates of cash outflows for similar risks are usually made on a portfolio basis and then apportioned to individual contracts. However, the estimates of cash inflows relate to the pricing of individual contracts. Accordingly the CSM of individual contracts with similar risks, contractual inception and maturity dates may be different if they were priced differently. Aggregating such contracts for the purpose of determining the CSM of the portfolio may not meet the principle of individual contract accounting. This is because large positive CSM balances associated with certain contracts would be able to absorb adverse changes in expected future cash flows from other contracts with a smaller CSM thus not providing for any losses on onerous contracts within that portfolio.

In the Board's view the clarified measurement principle should ensure that the level of aggregation is appropriate for measuring different elements of the insurance contract, including the CSM. Given that the difference in the pricing of contracts only affects the measurement of the CSM, the Board decided to broaden the definition of a portfolio removing the 'similarly priced' criterion. A portfolio will therefore be defined as 'insurance contracts that provide coverage for similar risks and are managed together as a single pool'.

The Board also considered a set of guidance criteria on the appropriate level of aggregation for the purpose of determining the CSM. For the purpose of determining the CSM on initial recognition, onerous and profit making contracts should not be combined, therefore an entity should consider the facts and circumstances to determine if a contract is onerous at initial recognition. After discussion this criterion was approved by the Board. This means that an entity can combine onerous and profit making contracts in the same portfolio. However, the effect of contracts that are onerous on initial recognition will need to be recognised separately in profit or loss and not aggregated with the other contracts in the portfolio. One of the consequences of this decision is that for policies that are subject to pricing regulation such as the gender neutral directive in the EU, some of the portfolio will be deemed to be "onerous" and some more profitable than those same policies would have been had it been possible to combine them and to price these contracts taking into account all risk factors including gender.

For the subsequent measurement of the CSM the Board considered the Staff proposal that entities could combine contracts that have similar:

- release patterns;
- absolute amounts of CSM at initial recognition;
- inception dates; and
- coverage periods.

While the notion of similar profitability was included in the 2013 ED definition of portfolio, most Board members disagreed with the need for the 'absolute' amounts of CSM on initial recognition to be similar. One unintended consequence envisaged by some members was that the absolute amounts of initial CSM can be different due to the difference in the sum insured, even if the relative pricing of risk and the risk itself remain the same. A majority of the Board members agreed that the other aggregation criteria were necessary to ensure that the CSM is released in full when the contract lapses, expires or becomes onerous. However, they felt that a well-articulated measurement principle, supplemented by examples of when it would not be met, would be better than adding a set of rules. Accordingly, the Board rejected the Staff proposal. A vote was taken on an alternative Staff proposal, which was to provide examples of how contracts could be aggregated for the purpose of determining subsequent CSM, while satisfying the newly approved measurement objective discussed above. The Board members approved this alternative proposal.

Finally, the Board considered the level of aggregation necessary for the application of the accounting policy choice to recognise the effect of changes in the insurance liability discount rate either in profit or loss or in other comprehensive income. During the March 2014 IASB meeting, the Board had tentatively decided that entities should apply the same accounting policy to all contracts within a portfolio. It has also planned to develop guidance that would have required entities to apply the same accounting policy to groups of similar portfolios.

During the June meeting, Board members and Staff agreed that inevitably there would be differences between entities and this would affect the comparability and consistency within an entity. However, two similar portfolios backed by different assets would be justified in having different accounting policies in order to avoid accounting mismatches. Given these considerations the Staff proposed the wording *"In accordance with IAS 8, an entity shall select and apply its accounting policies consistently for similar contracts, considering the portfolio the contract is included in and the related assets that the entity holds."*

During the discussion it was clarified that there would be no need to prove a contractual link between insurance liabilities and related assets, and there would be no requirement for the assets to back the liabilities in a particular way. The Staff also confirmed its intention that, provided the insurance contracts portfolio itself has not changed, the accounting policy should not be changed for a portfolio of insurance contracts simply because the asset mix has changed, even if this resulted in accounting mismatches. Given that the main reason for providing an accounting policy choice was to avoid accounting mismatches, the Staff proposal was re-worded.

The Board approved the clarification that, in accordance with IAS 8 *"an entity should select and apply its accounting policies consistently for similar contracts, considering the portfolio in which the contract is included, the assets that the entity holds and how those assets are accounted for."*

This re-worded clarification avoids the reference to a link between insurance contracts and insurer's assets and specifically mentions accounting mismatches.

Deloitte position on the "OCI solution"

Extract from DTTL Comment Letter on the 2013 ED:

"We believe the final IFRS should allow insurers to designate which insurance contracts will be accounted for using the "OCI solution" and which will be accounted by reflecting all changes in discount rate entirely through profit or loss. We recommend that an irrevocable, unconstrained designation should be made available at initial recognition of an insurance contract for the accounting treatment of their associated interest expense. We believe that this requirement is paramount in promoting consistency and comparability across reporting periods and market participants."

Rate used to accrete interest and calculate the present value of cash flows that unlock the CSM (decided at the July 2014 IASB meeting)

During the July meeting, the IASB considered the appropriate rate to use to accrete interest on the CSM and to calculate the present value of cash flows that unlock the CSM. The Staff recommended that an entity should use the locked-in rate at the inception of the contract for contracts without participating features.

Permitting an accounting policy choice was suggested, similar to the use of OCI for changes in the discount rate, which would allow entities to choose between using the locked-in rate at the inception of the insurance contract or the current rate used for measuring the insurance contract at the end of the reporting period. The Staff noted that similar proposals had been received from several constituents, but the accounting policy election for the use of the OCI solution for changes in the discount rate is a presentation matter with no change to the measurement of the liability, whereas this accounting policy election would apply to the measurement of insurance contracts. The Staff believes that this could reduce the comparability of financial statements if two identical contracts have different liabilities simply because of the different rate selected to accrete the time value of money on the CSM.

There was support for the use of the current rate rather than a locked-in rate, as requiring a locked-in rate is a burden for entities not using the OCI option as they would be forced to keep information on locked-in rates only for CSM accounting purposes. Also there is a problem with understandability when using the locked-in rate. For entities who choose the OCI option the locked-in rate makes more sense, but the difficulty for them in using current rates is that this does not result in the full recycling of the amount included in OCI.

A lot of comfort can be gained from the fact that the use of OCI did not affect the balance sheet. An accounting policy choice for the CSM accretion rate was of concern as the insurer would not end up with the same answer under each choice. For these reasons using the locked-in rate was considered to be preferable.

The Staff recommendation of using the locked-in rate at contract inception was approved by the Board.

This tentative decision will achieve consistency in the use of a locked-in rate for accreting interest on the CSM and calculating the present value of cash flows that unlock the CSM without affecting the measurement of the insurance contract at current rates. However, there will be significant, otherwise unnecessary additional administrative requirements placed on insurers who otherwise are using the fair value option.

Changes in accounting policy (decided at the July 2014 IASB meeting)

At the July meeting, the IASB considered existing requirements for changes in accounting policies and considered if any further requirements were necessary for insurance contracts.

The Staff recommended that an entity should apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to changes in accounting policy relating to the presentation of the effect of changes in discount rate, which would require retrospective application of the new policy.

The requirements of IAS 8 are that an entity would need to justify a change in accounting policy as providing reliable and more relevant information, and the justification for changes in accounting policy would be disclosed.

There was some disagreement with the Staff recommendation as when the accounting for financial assets is changed prospectively because of an IFRS 9 reclassification requirement, the accounting for insurance contract liabilities should not also be changed retrospectively.

The Board members were in favour of the Staff recommendations.

This tentative decision is consistent with the current requirements for justifying a change in accounting policy applicable to all entities reporting under IFRS.

Premium allocation approach (decided at the September 2014 IASB meeting)

Revenue recognition pattern

At the September meeting, the IASB considered two issues where the PAA is adopted, being whether to provide guidance on the pattern of recognition of insurance contract revenue and how to determine the interest expense for the liability for incurred claims.

As detailed above the IASB has clarified that the allocation pattern for the CSM in the general measurement model should be based on the provision of insurance coverage, and the provision of that service should be based on the passage of time.

The first Staff recommendation under the PAA was that insurance contract revenue should be allocated in profit and loss in a systematic way that best reflects the transfer of services, and that the IASB should clarify that the transfer of services occurs on the basis of the passage of time and the expected number of contracts in force. However, if the expected pattern of release from risk differs significantly from the passage of time, the expected timing of incurred claims and benefits should instead be the basis. The Staff stated that guidance was needed on the recognition of revenue to prevent diversity of approach and a lack of comparability.

In essence, there is a presumption that under the PAA the release of risk is on a straight-line basis over the period of insurance coverage of each contract. However, where the release of risk significantly differs from that of the passage of time, then insurance contract revenue would be recognised on the basis of the expected timing of incurred claims and benefits. This would be the case, for example, for catastrophe insurance against losses arising from hurricanes. The risk of incurring a loss is greater during the hurricane season and the difference in the timing of risk would have to be captured in the revenue allocation using the expected timing of incurred claims as a proxy.

The value as well as the number of contracts was considered to be relevant, and the Staff confirmed that they would clarify this. There were questions about the meaning of the transfer of services, and whether this was limited to claims or also included other costs that are incurred over the duration of the contract and the stand-ready obligation to meet claims. The Staff clarified that if the straight-line presumption is rebutted, the revenue recognition pattern would be based entirely on expected claims and benefits.

The Board members voted in favour of the Staff recommendations.

This tentative decision will effectively result in the recognition of revenue in line with the release from risk.

Determination of interest expense in the PAA

Under the PAA, the liability for incurred claims is measured in the same way as that under the general measurement model, which requires insurers to discount the liability using a current yield curve.

The Staff recommended that when the effects of changes in discount rates are presented in OCI, the discount rate that is used to determine the interest expense for the liability for incurred claims should be the rate locked-in at the date the claim was incurred. This is a change from the 2013 ED, which required the use of the discount rate at inception. This requirement will also apply to an onerous liability recognised in the coverage period under the PAA, in which case the discount rate will be the rate at the date that the onerous liability is recognised.

The Staff paper noted that if the rate at inception of the contract is used, a catch-up adjustment must be recognised in OCI to reflect the effect of changes in discount rates between the inception date of the contract and the date the claim was incurred. This catch-up adjustment may be difficult to explain because no gains or losses would otherwise be separately recognised in the statement of comprehensive income relating to any changes in assumptions between the date of inception of the contract and the date the claim is incurred. In the Staff's view this catch-up adjustment would mean that using the discount rate locked-in on a date other than the date the claim was incurred would add complexity for users to understand financial statements without bringing significant benefits.

After limited discussion, the Board members voted in favour of the Staff recommendations.

This change is a practical expedient for preparers, whose claims systems usually do not keep a record of incurred claims based on the contract inception dates they relate to.

Initial application for Insurance Contracts with no participating features (decided at the October 2014 IASB meeting)

At the October meeting the IASB considered the initial application of the proposed IFRS for contracts with no participating features.

The Staff recommended that at the beginning of the earliest period presented, an entity should apply the proposed IFRS retrospectively in accordance with IAS 8 unless this is impracticable. This date is also referred to as the transition date and it is the first day of the period shown in the comparative amounts of the financial statements prepared using the new IFRS. For example, if the effective date of the new IFRS was periods beginning on 1 January 2019 the reporting entity that prepares calendar year financial statements with one comparative column would have its transition date on 1 January 2018.

The Staff observed that this recommendation provides comparability between contracts written before and after the date the new IFRS is applied, provides information necessary for trend analysis and also addresses the concerns expressed in the feedback received on the 2010 ED.

There was a comment that full retrospective application would not be appropriate for many insurers because of the significant diversity of regulatory requirements in each country and because of the material fluctuations in interest rates over the periods that would be covered by the contracts in force at the transition date. These facts could penalise insurers in some jurisdictions. There are several developing insurance markets where there is not a market for long-term government bonds. Insurers are therefore obliged to invest in shorter-term assets and they would be faced with considerable practical problems when the new IFRS is adopted for the first time. The Staff stated that such insurers would be able to make an accounting policy choice to account for the effect of changes in discount rate in OCI.

There was concern that there will be insurers that, although having positive equity on a fair value basis, would be obliged to record artificial negative equity accumulated OCI at the date of transition to the new IFRS, and would recycle this to profit or loss over many years to come. An example was cited of long duration contracts issued in Asian markets where interest rates had subsequently reduced and which would result in significant negative equity arising on the first time adoption of the new IFRS.

There was a comment that where losses had been recognised under the previous GAAP, these would be recognised again under the new model. It was expressed that the IASB should allow some alternative method other than retrospective application, and should permit the progressive introduction of the new requirements as the changes will be so significant.

However, there was support for the Staff recommendation, as it was felt that the IASB needs to make its best attempt to achieve comparability on initial application rather than implementing the proposals over the remaining lives of the contracts in force at the date of transition. Also, the presentation and disclosure requirements would ensure that the readers of the financial statements would not be misled.

The Staff stated that the definition of 'impracticable' for the new IFRS was the same as the definition in IAS 8.

The requirement for full retrospective application was questioned because of the extraordinary complexity, subjectivity and cost. Concern was expressed at the prospect of individual insurers being able to adopt full retrospective application for some products and business lines but not for others, on the grounds that this was impracticable. The view was expressed that a fair value/fresh start approach, without the use of OCI, should be permitted at the date of transition.

The IASB was not considering prospective application of the new model, and the view was expressed that full retrospective application should not be taken off the table, and there should be no grandfathering provisions for contracts in force at the date of transition.

The Board members voted in favour of the Staff recommendation.

Whether the simplified restatement approach proposed in the 2013 ED should be modified (decided at the October 2014 IASB meeting)

The simplified restatement approach in the 2013 ED requires the risk adjustment at the inception of a contract to be set at the same level of the risk adjustment at the beginning of the earliest period presented, i.e. the new IFRS transition date. This approach would understate the risk adjustment in most cases compared to what it would have been if it had been calculated at that point in time. Given the CSM accounting approach this simplification would overstate the CSM. The Staff therefore recommended that if retrospective application of the proposed Standard is impracticable, an insurer should use a modified version of the simplified restatement approach proposed in the 2013 ED. Under this modified version an insurer would estimate the risk adjustment at contract inception by adjusting the risk adjustment at transition date by the expected release of the risk before that date. The expected release of risk should be determined by reference to similar insurance contracts that the insurer issues at the transition date.

The Board members agreed with the Staff recommendation.

Deloitte position on initial application

Extract from DTTL Comment Letter on the 2013 ED:

"We agree that, conceptually, a full retrospective approach is the most appropriate and accurate method of adopting the 2013 ED. In particular, we agree with the decision made by the IASB that if retrospective application is impracticable an insurer need not undertake exhaustive efforts to obtain objective information but should take into account all objective information that is reasonably available to determine the approximate amounts for the restated opening balance sheet. This approach should facilitate the determination of a sufficiently large number of prior periods that would be restated on the first time adoption of the new IFRS. For all contracts issued prior to that period the new IFRS should not require the computation of a CSM and the insurance contracts would be recognised based on the fulfilment cash flows only (inclusive of a current measure of the associated risk adjustment liability)."

Whether an alternative 'fair value approach' should be applied when it would be impracticable for an insurer to apply the simplified restatement approach (decided at the October 2014 IASB meeting)

The simplified restatement approach addresses the use of hindsight by effectively requiring the use of complete hindsight. The Staff suggested that a fair value approach should be introduced in addition to the simplified restatement approach to deal with situations where there is also a lack of historical information that would give the insurer the required hindsight.

When this lack of hindsight presents itself, the use of the simplified restatement approach becomes impracticable. In that scenario, an entity should apply a 'fair value approach' at the transition date, using current interest rates to estimate the fair value of the contracts and computing the CSM as the difference between this fair value and the fulfilment cash flows also calculated at the transition date. A loss in retained earnings would be recognised if the difference is negative.

The insurer would determine the discount rate to account for the interest expense in profit or loss, and the related amount of OCI accumulated in equity, by estimating the discount rate at the date of initial recognition of the insurance contract using the method in the simplified approach. This approach requires the identification of a reference market interest rate and the performance of a detailed adjustment process for the past three years (top-down or bottom-up) which produces an average spread discount or premium that is then applied mechanically to the same reference market interest rate observed in all other prior years.

The Staff noted that the CSM would not be based on the premium that had been charged for the contract, therefore there would be some lack of comparability for long duration contracts that were calibrated to fair value.

Discount rates would not be known for Asia, as 30 years ago government bonds might have had a maximum period of redemption of five years, therefore the recommendation was considered to be unrealistic. The Staff responded by stating that in such situations the yield curve would have to be extrapolated using the guidance that had been developed for this purpose.

The view was expressed that allowing three different approaches to transition within the same insurer would undermine comparability. It was felt that insurers may try to justify an extensive use of the fair value approach as this may be attractive in respect of the recognition of future profits.

The Staff noted that the definition of 'impracticable' under IAS 8 has always been a high hurdle. The Staff expressed the view that the matters raised were not a conceptual concern but a cost/benefit issue and stated that it would be carrying out a simplification review of the proposed IFRS, which would consider the costs and benefits of the proposals when the current deliberations are complete.

The Staff recommended that for each period presented for which there are contracts that were measured in accordance with the simplified restatement approach or the fair value restatement approach, an insurer should disclose the information for these contracts separately.

The Board members voted in favour of the Staff recommendations.

Designation of financial assets - transition relief (decided at the January 2015 meeting)

The interaction of the new IFRS for insurance contracts and IFRS 9 has been a critical issue throughout the two projects and this has taken an even greater emphasis given the effective dates of the two IFRS will be different with IFRS 9 being effective on 1 January 2018 and the new IFRS for insurance contracts at a later date not earlier than 1 January 2019.

The 2013 ED had already proposed certain mechanisms to protect the insurer from the effects of a sequential adoption of the two new IFRS in that (a) an entity was permitted to newly designate financial assets under the fair value option as measured at fair value through profit or loss to eliminate (or significantly reduce) an accounting mismatch; (b) an entity was required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation no longer exists; and (c) an entity was permitted to newly designate an investment in an equity instrument as measured at fair value through other comprehensive income and is permitted to revoke previous designations.

The Staff proposed to retain all these provisions and the Board members were in favour reconfirming the transition relief proposals in the 2013 ED.

In addition, given that many preparers are concerned that they will be required to apply the classification and measurement requirements of IFRS 9 without the opportunity to fully evaluate the implications of the new IFRS for insurance contracts, the Staff asked if the Board would consider providing further transition relief to permit or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts Standard.

The conceptual basis for a reassessment of the business mode was questioned, as there was a belief that if the business model has changed then the entity should apply the reclassification criteria in IFRS 9. Also, as the business model requires an objective assessment of the facts and circumstances, a proposal to reassess the business model upon adoption of a new IFRS would defeat the very notion of a business model as contemplated in IFRS 9.

In response to this, the need to differentiate between the 'reassessment' approach recommended in the proposal and the 'reclassification' criteria set out in IFRS 9 is important. The latter sets a high hurdle for entities to reclassify financial assets, not least requiring the existence of externally observable evidence to justify this change, which may be lacking for entities transitioning onto the new IFRS for insurance contracts. Entities could have reasonable arguments for changing their business model for their financial assets when they apply the new IFRS for insurance contracts therefore the IASB should simplify the mechanics to facilitate the accounting to reflect such changes in the business model. This would avoid the situation of these entities being 'locked-in' to an IFRS 9 classification based on the existing IFRS 4 guidance.

It was suggested that the IASB should consider deferring the effective date of IFRS 9 for entities that issue insurance contracts due to the costs involved in having to adopt two major IFRSs within a short period of time, and effectively having to apply IFRS 9 twice by having to revisit the classification and measurement and impairment judgements made previously.

Although it was recognised that it is sub-optimal to have different effective dates for IFRS 9 and the new IFRS for insurance contracts, there were objections to deferring the application of IFRS 9 on that basis as there are major concerns regarding the identification of the population of entities, and the assets and liabilities of such entities, that would qualify for this exemption. If such an identification of assets and liabilities could be made, this would lead to an even bigger concern of having similar items being accounted for under two different standards, being IAS 39 and IFRS 9, within the same entity and across entities. It was also noted that IFRS 9 is a significant improvement to IAS 39, not least in the impairment of assets model, and given the inextricably linked nature of the classification and measurement requirements with the impairment requirements, it would be appropriate to permit the deferral of application of IFRS 9 for certain entities. It was noted that as the new IFRS for insurance contracts is not yet finalised, deferring the adoption of IFRS 9 for insurance entities would potentially mean exempting entities from applying IFRS 9 for an unknown period of time.

As the new IFRS for insurance contracts is likely to be published before the mandatory effective date of IFRS 9, entities would be in a position to consider the interaction of this new IFRS with IFRS 9 when implementing the latter. In addition, given that the intervening time between the effective date of IFRS 9 and that of the new IFRS for insurance contracts is expected to be short (Deloitte estimates that this is likely to be one year only), changes in the business model are expected to be insignificant.

The Board members were in favour of the Staff proposal and decided not to defer the mandatory effective date of IFRS 9 for entities that issue insurance contracts.

The IASB will discuss the consequential issues arising from the Board's decisions at a future meeting. These issues include whether the Board should 'permit' or 'require' the new IFRS 9 transition relief, and whether a change in the assets' classification should be applied prospectively or retrospectively.

Next steps

The IASB intends to reach tentative decisions on contracts with participating features during the summer of 2015, and is planning to issue the new IFRS for insurance contracts by the end of 2015.

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