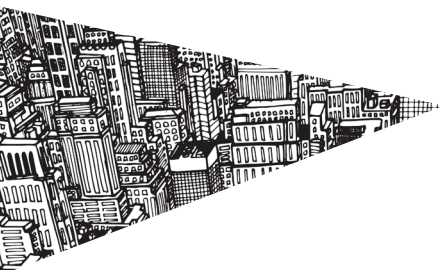


Insurance Accounting Alert

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March 2014



IASB makes use of OCI optional and confirms unlocking of the Contractual Service Margin

What you need to know

- ▶ The IASB tentatively decided to permit an accounting policy choice to recognise the effect of changes in discount rates in either OCI or profit or loss.
- ▶ The IASB confirmed the contractual service margin (CSM) is unlocked for changes in expected future cash flows relating to future coverage and other future services and tentatively decided to extend CSM unlocking to the risk adjustment.

Overview

During its March 2014 meeting, the International Accounting Standards Board (IASB, or Board) started re-deliberations on its 2013 Exposure Draft *Insurance Contracts* (ED). The Board discussed the following two changes to the ED:

- ▶ Whether to confirm the mandatory use of Other Comprehensive Income (OCI) for recognising the effects of changes in discount rates or to make the use of OCI optional
- ▶ Whether to confirm unlocking of the Contractual Service Margin (CSM) for changes in the expected present value of cash flows for future coverage, including how to treat losses previously recognised, and whether unlocking the CSM should be extended to changes in the risk adjustment

The staff noted that the approach taken to the accounting for participating contracts will be key to resolving many of the concerns about the ED. The topic of participating contracts will be discussed in a future meeting.

Other comprehensive income

Whether to make the use of OCI optional

One of the key concerns raised in the comment letters to the ED was the fact that the requirement to reflect the effect of changes in discount rates in OCI could cause accounting mismatches. The staff highlighted that, whilst the use of OCI provides an effective mechanism for achieving a consistent accounting treatment for situations where an entity invests in a fixed income financial instrument, insurance companies have diversified investment portfolios backing their insurance contract liabilities. As a result, mandating the use of OCI for insurance liabilities may introduce accounting mismatches that did not exist under the proposals in the 2010 ED. Also, in some jurisdictions, entities are accustomed to reporting the effect of changes in discount rates for both assets and liabilities in profit or loss. Such jurisdictions might see the mandatory use of OCI as a retrograde step for their reporting.

The staff was sympathetic to these arguments. Indeed, they were persuaded that the better way to use OCI would be to retain its use, but with the provision of an option to recognise the effect of discount rate changes in profit or loss.

A few board members expressed concern about the staff's recommendation, either because they were sceptical about the concept of OCI to begin with or because they were concerned an option would lead to diversity and would be difficult to understand.



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Most Board members support the use of OCI because it would enable users to better distinguish the effect of expected future cash flows from the short-term effect of changes in market rates. At the same time, they acknowledge that entities may have different models for fulfilling their insurance obligations based on characteristics of their products and/or their jurisdictions. In addition, under IFRS 9 *Financial Instruments*, some assets can only be carried at fair value through profit or loss (FVPL). In such cases, performance reporting might be better represented by recognising the effect of interest rate changes in profit or loss. The option to use OCI would allow both performance reporting perspectives to co-exist within the insurance standard.

The Board supports the staff's recommendation to confirm the use of OCI and to explore the inclusion of an option that would permit entities to present the effects of discount rate changes in profit or loss; thirteen members voted in favour and three members voted against.

An option for presenting discount rate changes in profit or loss

Once the Board agreed to explore an option for presenting discount rate changes, they discussed how it could be incorporated in the future standard. The staff elaborated on the two areas on which the Board would have to decide in respect of this option:

- ▶ **Unit of account** - Staff noted that they would have to decide at what level to apply the option: the entity level or the portfolio level. Application at the entity level would be less complex, but would not allow entities to reflect differences in how portfolios of insurance contracts and the assets backing these contracts are managed. However, application of this variant might introduce more complexity. Nevertheless, the staff recommended setting the option at the portfolio level.

- ▶ **Irrevocable election or an accounting policy choice** - In the staff's view, an irrevocable option at inception would result in consistent application within one entity, but could also lead to unwarranted accounting mismatches during subsequent years if the composition of assets changes. The staff therefore believes an accounting policy choice would be the preferable approach as it would fall within the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Changes in accounting policy, if made, will be transparent to users.

Some Board members disagreed with the staff's proposal and expressed concern about the lack of transparency and understandability of an entity's performance result. In their view, an accounting policy choice at the portfolio level would be open to abuse; entities could, in substance, avoid the barriers of IAS 8 for changing an accounting policy by simply opening a new portfolio. Further, the Board members felt comparability could be impaired by the fact that, within one entity, diversity would exist across all its portfolios on whether changes in discount rates are recognised in OCI or profit or loss.

Most Board members expressed agreement with the staff's recommendations. These Board members noted the portfolio level would be consistent with how entities implement their asset-liability management (ALM) model. They added that an entity's ALM model can change over time and an irrevocable option would undo the purpose for having the option in the first place. Moreover, as a result of the Board's proposed classification and measurement model for financial instruments, there could be a situation where the asset classification (through OCI or through profit or loss) changes without the ALM model actually changing. In the view of the Board members supporting the staff recommendation, this warranted that the option should not be irrevocable.

Despite the fact that most Board members support the staff proposal, many are concerned about the lack of discipline and the feasibility to designate and re-designate assets backing insurance liabilities. Several Board members also remarked that they were of the impression that, in practice, an entity's ALM model would be set at the level of a collection of portfolios (i.e., somewhere between the entity level and the portfolio level). Specific application items raised by Board members are:

- ▶ Whether retrospective application under IAS 8 would be appropriate given that the way an entity manages its assets and liabilities is a matter of fact
- ▶ The treatment of balances in OCI when the entity changes its policy to recognise changes in profit or loss instead of OCI

Based on the Board's desire to achieve greater comparability and discipline, the staff modified its original recommendation and proposed that an entity should choose as its accounting policy whether to present the effect of changes in discount rates in profit or loss or in OCI, subject to the staff developing further guidance on:

- i. Entities applying the same accounting policy to groups of similar portfolios (e.g., when are portfolios similar)
- ii. Sufficient rigour about when entities could change accounting policies based on the requirements for changing accounting policy in IAS 8

Thirteen Board members supported this proposal.

Disclosures

To allow users to compare financial statements, the staff proposed including the following disclosure requirements in the future standard on insurance contracts:

- ▶ For each portfolio of insurance contracts, an analysis of total interest expense included in total comprehensive income disaggregated, at a minimum, into:
 - i. The amount of interest accretion determined using current discount rates
 - ii. The effect on the measurement of the insurance contract liability of changes in discount rates in the reporting period
 - iii. The difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period, when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the contractual service margin when measured at current rates

The Board did not specify in which particular sequence the items i-iii above should be analysed.

- ▶ For portfolios of insurance contracts, for which the effect 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:
 - i. Interest accretion at the discount rate that applied on initial recognition of insurance contracts reported in profit or loss for the reporting period
 - ii. The movement in OCI for the reporting period

Board members generally consider the disclosures to be useful and believe they would help to understand the performance of an entity that recognises discount rate changes in OCI for some portfolios and in profit or loss for other portfolios. Fifteen Board members support the staff recommendation.

How we see it

The Board's concerns about whether to make the use of OCI optional shows there is no single solution within the context of the insurance project: an option would not be perfect, but neither would the mandatory use of OCI or the mandatory use of profit or loss. In the absence of a perfect solution, the decision to make the use of OCI optional is a compromise necessary to complete the insurance contracts project. Having an option allows entities to reflect the differences that exist in how they run their businesses to fulfil their obligations under their insurance contracts.

Contractual service margin

The staff first asked the Board to confirm the treatment of the CSM proposed in the ED. Board members broadly support CSM unlocking as, in their view, it would achieve a faithful presentation of remaining unearned profit. Further, the concept of unlocking the CSM would align with the Board's revenue recognition proposals. Board members generally believe the standard should refrain from providing very detailed guidance on how to apply unlocking and the periodic release of the CSM to profit or loss.

The staff reminded the Board that the 2013 ED proposed the CSM would be adjusted (i.e., unlocked), as follows:

- ▶ For changes in estimates of the present value of expected future cash flows to the extent those changes relate to future coverage and other future services
- ▶ Changes in estimates related to the current period or the past should be reported in profit or loss
- ▶ The release of the CSM for future coverage and other future services over the remaining life of the contract should be done on a prospective basis (i.e. no retrospective cumulative 'catch-up' adjustments)
- ▶ The CSM for each portfolio would have a 'floor' of zero; any effect of changes in future cash flows should be recognised in profit or loss once the CSM has been reduced to nil

One Board member noted that the intention of the ED is to apply unlocking by discounting the previous and new estimates of future cash flows at the discount rate at inception, but pointed out using the rate at inception would add complexity if changes in discount rates are recognised in profit or loss and the rate for interest accretion is the current rate. The staff agreed this issue requires further investigation and plans to revisit it at a future meeting.

The Board unanimously supported the staff's recommendation to confirm the proposals for unlocking in the ED.

The staff then introduced the following two issues that were raised in comment letters:

- ▶ Should previous losses recognised in profit or loss be reversed before the CSM is reinstated?
- ▶ Should the CSM be unlocked for subsequent changes in the risk adjustment?

When a CSM becomes nil and, in subsequent periods, favourable changes in expected future cash flow arise, the ED proposed that an entity would immediately start building up a new CSM in those subsequent periods. Many respondents to the ED pointed out that the alternative - first reversing the losses recognised in profit or loss in previous periods before starting to reinstate the CSM - would be more consistent with other IFRSs, including the treatment of onerous contracts under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. These respondents felt the benefit of reversing previous losses would outweigh the increased complexity.

The staff, therefore, recommended that subsequent favourable changes in estimates should be recognised in profit or loss to the extent they reverse losses recognised in previous periods that relate to coverage and other services in future periods. Changes to expected future cash flows that relate to past and previous services should not unlock the CSM.

Some Board members queried whether the need to track the reversal of losses would entail complex administrative procedures. The staff responded that such procedures should not be unduly onerous as entities could simply determine the negative margin in the same way the positive margin is determined, but they must not recognise a CSM amount on the balance sheet as long as the accumulated CSM remains negative. With that clarification, the Board unanimously voted in favour of the staff's recommendation.

The staff introduced the second follow-up topic by reminding the Board that the ED proposes that changes in the risk adjustment should be recognised in profit or loss because that would result in greater transparency for (changes in) the exposure to insurance risk coverage.

However, many respondents to the ED would prefer to unlock the CSM for subsequent changes in the risk adjustment. These respondents believe this approach would be consistent with how the margin is established on day one and how subsequent changes in future cash flows are treated. The staff was persuaded by these responses and recommended that the CSM should be unlocked for differences between current and previous estimates of the risk adjustment that relate to future coverage and other services (provided the remaining CSM balance remains positive). As a result, changes in the risk adjustment that relate to services provided in the current and past periods should be recognised immediately in profit or loss.

Some Board members challenged whether, in the case of unlocking the CSM for changes in the risk adjustment, it would still be useful to retain two separate margins within the proposed measurement model. The staff still feels strongly that a separate risk adjustment is useful, for example, in determining whether a contract is onerous, or to reflect the insurance risk exposure in long-duration incurred claims liabilities. After further discussion, the Board unanimously agreed with the staff's proposal.

How we see it

The Board's decisions reflect its comfort with the concept of unlocking the CSM and they also show that it has been responsive to the follow-up issues raised in the comment letters. However, the Board will face a more challenging debate when, at a future meeting, it revisits the treatment of the CSM within the context of participating contracts.

What's next?

The Board's next meeting on the insurance contracts project will be in April. At that meeting, the Board plans to discuss the topic of insurance contracts revenue. In addition, it will consider other issues raised in responses to the ED related to topics on which it did not ask specific questions in the ED. The issue of participating contracts will be considered at a later stage.

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EYG No.AU2276

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