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Insurance Accounting Alert

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IASB adopts variable fee approach for certain participating contracts

What you need to know

- The IASB tentatively decided to modify the proposed insurance accounting model for contracts with participation features based on the variable fee approach.
- This approach will apply only to contracts that meet certain criteria.
- The CSM for these contracts will be recognised in profit or loss on the basis of the passage of time.

Overview

During its June meetings, the International Accounting Standards Board (IASB or Board) continued re-deliberations and was asked to make a tentative decision on the following topics:

- Whether to adopt a variable fee approach for participating contracts that meet certain criteria.
- How to recognise the Contractual Service Margin (CSM) in profit or loss under the variable fee approach.

The IASB also held an educational meeting to discuss:

- The interaction of the effective date of IFRS 9 *Financial Instruments* and the new insurance contracts standard (IFRS 4 Phase II), in particular:
  - The application of IFRS 9 before IFRS 4 Phase II is adopted, and the potential IFRS 4 *Insurance Contracts* (IFRS 4 Phase I) accounting implications thereof
  - Complexities of deferring the effective date of IFRS 9 for the insurance industry
- Hedging of risks relating to insurance contracts, in particular, the challenges and potential mismatches that could arise for contracts accounted for under the variable fee approach

No decisions were made during the educational meeting.

The story so far

The IASB's website provides information about tentative decisions made on the insurance contracts accounting model prior to this meeting, including:

- The cover note for the Insurance Board papers for the June meeting which contains a summary of progress so far[1]
- Further information on the project and the proposed model[2]

Adaptations for participating contracts (decision-making)

The IASB's staff proposed a measurement model for participating contracts where changes in the estimate of the future fees that an entity expects to earn from participating contract policyholders are adjusted against the CSM (the variable fee approach). This fee, at inception, comprises the entity's expected share of returns on the underlying items to which the participating contracts have a participation right less any expected cash flows that do not vary directly with the underlying items (e.g., guaranteed minimum benefits and expenses).

The staff recommended that the variable fee approach should apply to participating contracts that meet all of the following features (so-called direct participating contracts):

- The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items
- The entity expects to pay to the policyholder a substantial share of the returns from the underlying items
- A substantial proportion of the cash flows that the entity expects to pay to the policyholder are expected to vary with the cash flows from the underlying items

Thirteen Board members agreed with the staff recommendation to adopt a variable fee approach for participating contracts that meet certain criteria. One Board member disagreed with the variable fee approach because the presence of guarantees can mean that the payment does not vary with the performance of underlying items, and it is impossible to separate the guarantee. An argument heard by those in favour of the variable fee approach being mandatory for qualifying contracts was that it is deemed the best reflection of economic reality.

A number of Board members suggested that it will be important to provide specific disclosures that show the impact of unlocking the CSM for changes in the variable fee during the period.

The Board members asked the staff how the proposed eligibility criteria for the variable fee approach should be interpreted and applied. The staff noted that certain aspects of the criteria may need to be further evaluated, in particular, to address whether re-assessment would be necessary in subsequent periods, although counter arguments were provided by the staff that the wider insurance contracts model generally does not apply reassessment of scoping. With this clarification, nine Board members agreed with the criteria proposed by the staff; five IASB members disagreed.

Most Board members agreed that the shareholder's interest in underlying items is more like a fee (compensation for service) than an interest in assets, and that, as such, it would be appropriate to recognise changes in estimates of that interest over time in line with changes to other items related to future services. One Board member wanted the scope of the variable fee approach extended to all contracts with participating features (even where payment of returns from underlying items to policyholders is discretionary).

[1] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/June/AP02-Insurance%20contracts.pdf

[2] http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx

The staff also recommended that for, direct participating contracts, an entity should recognise the CSM in profit or loss on the basis of the passage of time. Twelve Board members agreed with the recommendation and two disagreed.

Whilst acknowledging that participating contracts may contain more than one form of service, most Board members agreed that the passage of time was the simplest approach, since insurance is a bundle of services that cannot be reliably measured separately. Other Board members raised concerns that they would ideally prefer an IFRS 15[3] approach to recognition of the CSM, in which the contract is broken down into separate performance obligations and released separately over time, in accordance with different drivers of revenue. One board member expressed reservations about the implication of the decisions for regular premium unit-linked contracts where the total CSM recognised in profit or loss at a point in time would exceed the total variable fee collected from the policyholders, which would require a catch-up/reversal of revenue (if lapses are greater than expected). The accounting for revenue on these contracts will also differ between contracts that are within the scope of IFRS 9 and those that will be within the scope of IFRS 4.

Hedging of risks relating to insurance activities

In the education session, the IASB explored a consequence of the variable fee approach that accounting mismatches could arise when the entity uses derivatives to reduce economic risk. The mismatch arises when changes in the insurance contract obligation are recognised in CSM, whereas the fair value movements in hedging derivatives are recognised in profit or loss.

The staff outlined possible approaches that could be explored for minimising these mismatches:

1. *Limited use of the variable fee approach.* This would allow an entity that hedges risks related to insurance activity either to use the variable fee approach and accept the accounting mismatch, or to recognise changes according to the general model. For example, it could elect to recognise the effect of changes in the interest rate on the insurance contract immediately in profit or loss to offset changes in the value of the derivative recognised immediately in profit or loss (this would not necessarily provide a perfect match, but it would give the entity more options).
2. *Optional recognition of some specified changes in the value of the insurance obligation in profit or loss* (for example, recognition of changes in value of financial guarantees) to match the recognition of the hedging instrument's movements in profit or loss.
3. *Optional designation of a notional 'perfect' derivative as an underlying item, to match the obligation.* Changes in the insurance obligation recognised in the statement of comprehensive income would include the change in value of the notional derivative, offsetting changes in the value of the derivative actually held. Ineffectiveness of the hedged relationship (the difference between the notional perfect derivative and the derivative actually held) would be recognised in profit or loss.

The discussion on these issues and approaches was broad ranging and lengthy because the proposed solutions were quite complex and a number of Board members were concerned about that introduction of the variable fee approach was giving rise to additional complications.

The first option was not seen as conceptually sound by some board members, as it introduces optionality into application of the variable fee approach, which may otherwise be expected to be mandatory. Also, it is a solution that is, in essence, not consistent with the logic of, or is not moving in the same conceptual direction as the variable fee approach. However, some acknowledged that it could be regarded as a quick and simple solution.

Concerns were raised on the second approach, since previous feedback had stressed the difficulty of unbundling and measuring guarantees separately, the whole model being built on interlinked and comingled cash flows relating to investment return, insurance protection and other elements. One Board member commented that taking this route at this stage of the project could potentially open a 'Pandora's box' and unravel the basis of the model.

Some Board members favoured the third approach as the most promising and most consistent with the variable fee approach. However, they recognised a need to understand its complexities and to identify the hedged item and hedging instruments clearly.

A concern was raised that the high hurdles for separate identification and reliable measurement of items qualifying for hedge accounting in IFRS 9 would not be met by either of the second or third approaches. Some members cautioned against insurance being granted a lower hurdle than other industries. If insurers could not meet the IFRS 9 hurdles for hedge accounting, perhaps they should have to deal with the volatility that results in the same way as other industries do, or apply the hurdle at a higher identifiable level with less effectiveness. A counter-argument was made by other Board members that insurance should be allowed a workable solution because, by nature, it generally will not meet hedge accounting criteria, although such a solution should be built within the variable fee approach rather than being linked too closely to hedge accounting requirements.

No decisions were made and the Board did not provide the staff with specific direction to resolve the issues.

[3] IFRS 15 *Revenue from Contracts with Customers*.

Application of IFRS 9 in advance of IFRS 4 Phase II

The staff reminded the Board that the European Financial Reporting Advisory Group (EFRAG) had advised the European Commission to ask the IASB to defer the effective date of IFRS 9 for the insurance businesses and to align it with the effective date of the new insurance contracts standard. Staff provided feedback from their monitoring and outreach on the issues.

Board members asked for further details to weigh the benefits and disadvantages of a deferral of IFRS 9 in terms of cost, potential volatility and usefulness of information. Whilst Board members appreciated that any disconnect between the effective dates of IFRS 9 and IFRS 4 Phase II would be suboptimal, they noted that deferral would also have its own shortcomings.

Some Board members noted it would be important to distinguish the additional accounting mismatches caused by IFRS 9 that would remain after IFRS 4 Phase II is adopted from additional mismatches that would be resolved with the introduction of IFRS 4 Phase II.

Board members also emphasised that the views of users of financial statements were key and should be fully sought and addressed and be sufficiently global in nature. It was noted users may want IFRS 9 applied consistently, since applying both IAS 39 and IFRS 9 at the same time could have more complexity than having to implement IFRS 9 before IFRS 4 Phase II.

Use of IFRS 4 Phase I to address the consequences of applying IFRS 9 before IFRS 4 Phase II

Staff noted that options are already available in the existing IFRS 4 (IFRS 4 Phase I) to reduce accounting mismatches that can occur when applying IAS 39 *Financial Instruments - recognition and measurement* (IAS 39). These options would continue to be relevant under IFRS 9 and could possibly be expanded.

Methods available include:

- Shadow accounting (which adjusts aggregate insurance liabilities to reduce accounting mismatches that can arise when unrealised gains and losses on assets held by the entity are recognised in the financial statements, but corresponding changes in measurement of liabilities are not)
- Selective use of current market interest rates for valuation of liabilities
- The ability provided by IFRS 4 Phase 1 to change accounting policies for insurance contracts if the change makes the financial statements more relevant to the economic decision-making needs of users (but no less reliable, or vice versa)

Further potential amendments to IFRS4 Phase I to mitigate the impact of IFRS 9 were also considered:

- Extending shadow accounting to all unrealised gains (and losses to the extent they are recoverable) on specified underlying items, i.e., including the shareholder's share of underlying assets
- Allowing entities to recognise a liability adjustment to reflect differences between changes in the value of assets under IAS 39 and changes in the value under IFRS 9 to the extent they are recognised in profit or loss, in effect to defer the effects of IFRS 9 without deferring the actual standard

Board members commented that an IFRS 4 Phase I solution is more targeted at insurers than a potential deferral of IFRS 9, and expressed interest in this approach until IFRS 4 Phase II is implemented. However, Board members commented further research would be needed to determine how this could work in practice, which assets would be in scope, and whether dual systems, reconciliations and further disclosure would be needed.

While one Board member preferred a solution of progression of the variable fee approach to allow its early adoption, the Board Chair noted that EFRAG's concerns require an urgent interim solution and that the existing shadow accounting approaches would be directionally consistent with the variable fee approach.

Complexity of deferral of the effective date of IFRS 9 for the insurance industry

The Board discussed three potential approaches to deferring IFRS 9 within the context of the new insurance standard, in case the Board were to decide to propose deferral. These consider the level in a reporting entity at which insurance operations would be identified and deferral would apply. The options presented were:

- The reporting entity level
- The legal entity level
- Below legal entity level

A number of complexities arise with each of the options, as follows:

- Board members stated that the reporting-entity level would be simplest, but this could run the risk of more entities continuing to apply IAS 39. It could also require complicated data conversion and costly dual-basis accounting for subsidiaries that apply a different standard at reporting-entity level than on a consolidated group basis.
- The entity level and below-entity level approaches would need to consider carefully the requirements of IAS 8 to apply a consistent set of accounting policies to all entities within a single set of financial statements, and could cause potential complexity and confusion for users, by applying IAS 39 and IFRS 9 simultaneously in either entity level accounts, or when consolidating results of different subsidiary entities.
- Board members want to minimise the extent to which banks continue IAS 39, and expect that regulators would want the same, and would prefer to deal with issues through liability adjustments instead of deferral of IFRS 9.

How we see it

It is a positive development, from the perspective of the insurance industry, that a clear majority of the Board voted to adopt the variable fee approach, providing the staff with momentum to resolve the discussions on participating contracts in the next few months.

Now that the Board has tentatively decided to adopt the variable fee approach for direct participating contracts, a working solution needs to be found for those participating contracts that do not qualify for the approach. In addition, the Board needs to address other important aspects of the approach to participating contracts such as level of aggregation and hedging.

The Board chose to be consistent with the general model in its approach to amortising the CSM on participating contracts in profit or loss. While there is some disagreement with this simplified approach in the industry, it is not clear that there is a better consistent solution.

Several Board members strongly prefer to resolve additional accounting mismatches caused by the implementation of IFRS 9 via the 'liability side' (i.e., through modifications to the existing IFRS 4). The Board is fully cognisant of the developments in its European constituency on IFRS 9 endorsement and is expected to closely monitor these developments over the next few months. The Board will carefully weigh the pros and cons of all possible solutions. Of course, insurers may be very reluctant to expend significant effort, and may face considerable challenges, in amending their accounting processes if these will be discarded when a new standard is applied. Additionally, there remains a risk that, even if IFRS 9 is delayed for insurers, the IASB could require disclosure of the impact assuming that the standard had been adopted. This would mean insurers have to develop the necessary systems and processes to perform calculations of the impact. We expect that the IASB will resolve the IFRS 9 implementation question in the next few months.

What's next?

The Board's next meeting on insurance contracts is expected to be in July. The topics have not yet been announced, but will likely cover re-deliberations on contracts with participating features that do not meet the criteria of the variable fee approach (so-called indirect participating contracts), and other topics discussed in recent education sessions, such as implementation of IFRS 9.

The IASB expects to publish the new standard in the course of 2016.

Area IFRS insurance contacts

	Telephone	E-mail
Global		
Kevin Griffith	+44 20 7951 0905	kgriffith@uk.ey.com
Jasper Kolsters	+31 88 40 71218	jasper.kolsters@nl.ey.com
Europe, Middle East, India and Africa		
Hans van der Veen	+31 88 40 70800	hans.van.der.veen@nl.ey.com
Pierre Planchon	+33 1 46 93 62 54	pierre.planchon@fr.ey.com
Nick Walker	+44 20 7951 0335	nwalker1@uk.ey.com
Stefan Schmid	+41 58 286 3416	stefan.schmid@ch.ey.com
Brian Edey	+41 58 286 4224	brian.edey@ch.ey.com
Martin Gehringer	+49 6196 996 12427	Martin.Gehringer@de.ey.com
Ralf Widmann	+49 7119 881 15142	Ralf.Widmann@de.ey.com
Matteo Brusatori	+39 02722 12348	Matteo.Brusatori@it.ey.com
Burton Leach	+27 11 772 5437	Burton.Leach@za.ey.com
Katrien De Cauwer	+32 2 774 91 91	katrien.de.cauwer@be.ey.com
Americas		
Dana D'Amelio	+1 212 773 6845	Dana.DAmelio@ey.com
John Santosuosso	+1 617 585 1867	john.santosuosso@ey.com
Evan Bogardus	+1 212 773 1428	evan.bogardus@ey.com
Doru Pantea	+1 416 943 3997	Doru.Pantea@ca.ey.com
Eduardo Wellichen	+55 11 2573 3293	eduardo.wellichen@br.ey.com
Mario Bittar	+54 11 4510 2377	mario.bittar@ar.ey.com
Asia Pacific		
Mike Wong	+852 28499186	Mike.Wong@hk.ey.com
Patrick Menard	+65 6309 8978	Patrick.Menard@sg.ey.com
Tze Ping Chng	+852 28499200	Tze-Ping.Chng@hk.ey.com
Kieren Cummings	+61 2 9248 4215	kieren.cummings@au.ey.com
Jeff Malatskey	+852 2849 9308	Jeff.Malatskey@hk.ey.com
Peter Telders	+852 9666 2014	Peter.Telders@hk.ey.com
Japan		
Norio Hashiba	+81 33 503 1100	hashiba-nr@shinnihon.or.jp

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