Overview
During the May 2014 meeting, the International Accounting Standards Board (IASB, or Board) continued re-deliberations on its 2013 exposure draft *Insurance Contracts* (ED). The Board discussed four of the seven non-targeted topics that were identified for further discussion during its April 2014 meeting.¹

The Board also held an educational discussion on the model for contracts that contain participating features (participating contracts).

Non-targeted issues
The respondents to the 2013 ED did not limit their comments to the five topics the IASB sought feedback on; they also raised additional issues (i.e., non-targeted topics). During the May meeting, the Board discussed the following four non-targeted topics:

- Pattern for recognising the contractual service margin (CSM) in profit or loss
- Scoping of fixed-fee service contracts
- Changes to guidance on significant insurance risk
- Recognition of contracts acquired through portfolio transfers and business combinations

Recognising the CSM in profit or loss
The staff reminded the Board that the ED included a principle to recognise the CSM in profit or loss in a systematic way that best reflects the provision of services. However, the ED did not include any further detail on how this principle should be translated into a release pattern, leading some respondents to ask for further guidance. The staff believes this principle remains valid and recommended the Board to retain it. All sixteen Board members agreed, but added that application guidance should be provided to reduce diversity in profit recognition patterns. The staff explained that the discussion for the May meeting would cover non-participating contracts only, the Board intends to hold a separate discussion on guidance it plans to give on the CSM release for contracts with participating features during a future meeting.

¹ See Insurance Accounting Alert, May 2014, *IASB confirms the use of insurance contracts revenue.*
The Staff indicated that they have explored ways of introducing application guidance that would specify in more detail (e.g., profit drivers) how to release the CSM on the basis of services provided. This is with the aim of both increasing transparency around how the CSM is released over time and improving comparability between entities.

Having considered a variety of potential ‘drivers’ for the release, the Staff concluded that, for non-participating contracts, the service of the insurer standing ready to provide insurance coverage would be the most logical alternative. The Staff noted that the separate risk adjustment already covers the entity’s exposure to uncertainty about the cash flows throughout the life of the contract. In the Staff’s view, the service of standing ready would therefore be depicted in a simple, time-proportionate way over the coverage period. The Staff believes this would be easier for users to understand and estimate, it would result in less diversity and earnings management and would also be easier to audit. The Staff added that it believes any basis for releasing the CSM will be arbitrary to a certain extent.

The Staff recommended that the Board clarifies through application guidance that, for non-participating contracts, the service represented by the CSM is insurance coverage that:

- Is provided on the basis of the passage of time
- Reflects the expected number of contracts in force

The Staff added the criterion that the release pattern should reflect the expected number of contracts in force, as it believes the quantum of service provided depends on the number of contracts – the more contracts in force, the higher the level of service.

Many Board members noted that, after having agreed with the principle, the Staff’s recommendation for application guidance would, in effect, convert the principle into a rule. They believe that this recommendation would undermine a principles-based standard and prevent the consideration of alternative release patterns where the basis of time would not result in the most appropriate pattern. However, other Board members expressed sympathy for the Staff proposal as the Board has always struggled to explain exactly what services are represented through the CSM. These Board members believe that stating the service is the provision of insurance coverage on a time-proportionate basis would bring clarity and simplicity.

In response to a question from Board members, the Staff confirmed that releasing the CSM on a time-proportionate basis does not necessarily mean insurance contracts revenue will be recorded on a time-proportionate basis as other building block elements that make up revenue (e.g., incurred claims and expenses) vary over time. Thirteen Board members agreed with the Staff recommendation and three disagreed.

**How we see it**

Throughout the recent stages of the insurance project, the Board selected a somewhat rules-based approach to certain elements of the model to limit the potential for incomparability. The Board seems to be aware that its decision to prescribe the CSM release creates a rule within a principles-based standard. Considering the Board’s desire to achieve comparability and transparency for the CSM release and the stage the insurance project is at, this rule may very well stick.

**Fixed-fee service contracts**

The Staff explained the ED would scope out fixed-fee service contracts that meet certain conditions and require entities to account for these under IFRS 15 *Revenue from Contracts with Customers*. Under such fixed-fee service contracts, a service provider agrees to compensate a customer by providing services in exchange for a fixed fee, for example, roadside assistance and the repair of equipment. Several respondents to the ED noted that they provide contracts that are a combination of fixed-fee services and insurance coverage. These respondents currently account for such contracts under IFRS 4 *Insurance Contracts* in their entirety and are concerned this scope exclusion would force them to split these contracts and account for them under different standards.

The Staff explained it was sympathetic to concerns that splitting these contracts might undo the intended simplification and cost reduction that the scope exclusion for fixed-fee contracts aimed to address. Therefore, the Staff recommended entities should be permitted, rather than required, to apply IFRS 15 to fixed-fee service contracts that also contain insurance coverage. The Staff added that comparability would not be impaired, as for these contracts, the accounting would be fairly similar either way.

Board members expressed some concern about diversity in practice as a result of introducing an option. Despite this concern, most Board members agreed with the Staff’s proposals as they would allow preparers to decide whether the practical expedient to account for these fixed-fee service contracts under IFRS 15 would make sense based on their particular circumstances. Fifteen Board members agreed with the Staff, one Board member disagreed.

**Definition of insurance contracts**

As an addition to the existing definition of an insurance contract in IFRS 4, the ED includes application guidance, which explains that a contract does not transfer significant insurance risk if there is no scenario with commercial substance in which the present value of the net cash outflows paid by the entity can exceed the present value of the premiums.

The Staff noted that some respondents to the 2013 ED felt that a literal interpretation of the guidance added in the ED could result in some contracts, that are commonly regarded as insurance contracts under the existing IFRS 4, no longer meeting the definition of an insurance contract. The Staff, therefore, proposed to change the wording in the application guidance to say a contract only transfers insurance risk if there is a scenario with commercial substance in which the entity has a loss on a present value basis. All sixteen Board members agreed with the Staff recommendation.
Contracts acquired through portfolio transfers or business combinations

Some respondents to the 2013 ED asked for clarification on whether to include a CSM in the measurement of a contract when it has been acquired through a portfolio transfer or a business combination after the coverage period has ended. Staff recommended that the guidance be reworded to clarify that acquired contracts should be accounted for as if they had been issued by the acquiring entity at the date of the portfolio transfer or business combination. The staff believed where the insured event has already happened under the original contract before transfer, the acquired contract would represent a new contract written by the acquiring entity, with the insured event representing the discovery of a loss or the adverse development of claims for past events. This means the acquiring entity provides coverage against the risk that ultimate losses from past events will exceed initial expectations. Staff concluded that this treatment is analogous to the application guidance on the definition of an insurance contract in the ED. Fifteen Board members agreed with the staff recommendation and one Board member disagreed.

Participating contracts (educational session)

The staff reminded the Board that the measurement and presentation exception for certain participating contracts (the so-called ‘mirroring’ approach) was rejected in many comment letters. The staff therefore felt it will be necessary for the Board to re-deliberate the accounting for participating contracts. The staff explained the purpose of educational discussion on participating contracts was to explore whether adaptations for contracts with participating features to the IASB’s proposed for contracts without participating features (non-participating contracts) are needed and asked the Board for feedback on the following aspects:

- How to measure the fulfilment cash flows
- Whether to unlock the CSM for an entity’s share in the underlying items
- How to recognise the CSM in profit or loss
- Where to recognise changes in expected future cash flows and the effects of options and guarantees
- How to present the interest expense on the insurance liability in profit or loss

During the discussions, the staff made reference to an alternative proposal for participating contracts (the “Alternative Industry Proposal”) that is being developed by some preparers. The Board members did not raise any specific concerns related to the measurement of the fulfilment cash flows. The measurement of the CSM attracted many comments and questions from Board members. A recurring question in these comments was to what extent did the provision of investment or other services actually reflect an (asset) management service under the contract? Some Board members expressed sympathy for regarding the shareholders’ share in underlying items as analogous to an explicit management fee in some cases. The Board asked the staff to further investigate whether the shareholders’ share could be seen as an (implicit) fee for services provided under the contract.

On options and guarantees, the staff noted the Board should think about both the intrinsic value (i.e., the value of the option or guarantee if it is in the money) and the time value. The ED proposed to recognise changes in the measurement of options and guarantees in profit or loss for those participating contracts that would be eligible for the mirroring approach. The ED did not contain specific proposals on how to treat changes in options and guarantees for participating contracts that would not fall within the scope of the mirroring approach. Under the Alternative Industry Proposal, options and guarantees could either be adjusted against the remaining CSM (unless nil) or reported in the statement of comprehensive income. Board members expressed various perspectives on how to present changes in options and guarantees.

The Alternative Industry Proposal applies a book-yield rate for determining the interest expense in profit or loss. That rate is consistent with how the underlying items supporting the contracts are reported in profit or loss. Some Board members were sympathetic to the idea of applying a book yield as it would resolve the accounting mismatches for profit or loss by accommodating the mixed measurement model for financial instruments. However, a number of Board members raised several issues on the book yield method, including how to apply it to derivatives that are used for hedging exposure to options and guarantees. One Board member suggested exploring whether the book yield approach could also be applied to non-participating contracts; no decisions were made during this education meeting.

During the IASB’s Accounting Standards Advisory Forum (ASAF) meeting in June, the IASB staff plans to ask ASAF members for their views on the accounting for participating contracts.2

How we see it

For many life insurers, participating contracts are a major part of their business. Thus far, the Board’s consecutive proposals on participating contracts have always attracted controversy. This makes the topic of participating contracts the most critical remaining issue for the IASB to resolve in order to finalise the project.

What’s next?

The Board’s next meeting on the insurance contracts project is in June; the topics have not yet been announced. The IASB expects to complete its re-deliberations on its insurance contracts proposals in 2014, with the publication of a final standard in 2015.

2 ASAF June 2014 Agenda papers.
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