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Insurance Accounting Alert

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IASB provides further guidance on the level of aggregation of the CSM

What you need to know

The IASB decided on certain narrow scope issues that have arisen in the drafting process of the forthcoming insurance contracts standard:

- Measurement of the CSM is at the level of a group of contracts. An entity should group together contracts which, at inception, have: (a) expected cash flows that are expected to respond similarly to changes in key assumptions; and (b) similar expected profitability.
- For contracts without direct participation features, experience adjustments and changes in estimates of present value of future cash flows ('adjustments') that relate to future coverage or other services adjust the CSM. Adjustments caused by changes in financial assumptions do not adjust the CSM.
- An entity has an accounting policy choice on whether to disaggregate changes in measurement of a risk adjustment between finance and underwriting components.
- If an entity disaggregates insurance finance income or expenses between P&L and OCI, this should be based on a systematic allocation in P&L over the life of the contract, and requires specified disclosures.
- Reinsurance contracts issued and reinsurance contracts held by an entity are outside the scope of the variable fee approach.

Overview

During the June meeting, the International Accounting Standards Board (IASB or the Board) discussed several sweep issues that arose during the drafting process for the forthcoming insurance contracts standard (IFRS 4 Phase II). The main topic was the measurement of the contractual service margin (CSM) after inception. Other topics included the adjustments to the CSM for changes in non-financial assumptions, presentation and disclosure of insurance finance income or expenses and whether the scope of the variable fee approach includes reinsurance contracts.

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 and papers on insurance for the February 2016 meeting contain an overall summary to date of the progress on the insurance contracts project and an overview of the tentative decisions made and the proposed model for insurance contracts: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Discussion-and-papers-stage-7.aspx
- Further information on the project and the proposed model: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx [1]

Level of aggregation for CSM

The Board considered the objectives for the level of aggregation to be applied in measuring the CSM after initial recognition. It decided that the objective for the adjustment and release of the CSM is that the CSM at the end of the reporting period should represent the profit for the future services to be provided for a group of contracts (rather than for an individual contract).

The Board also decided that the group used for measuring the CSM should be the same as the group that determines whether contracts are onerous. Consequently, an entity should group together contracts that at inception have:

- Expected cash flows that the entity expects will respond in similar ways to changes in key assumptions in terms of amount and timing
- Similar expected profitability (i.e., CSM as a percentage of the total expected revenue or premiums).

The Board also clarified that, for allocating the CSM of the group of contracts to profit or loss over the coverage period, an entity should ensure that the remaining balance of the CSM reflects the expected duration and size of the contracts remaining at the end of the period in that group.

The Board expects to receive input on the practical application of the above guidance on level of aggregation from targeted testing of the proposals and other outreach during the drafting process.

There was consensus amongst Board members to remove previous references to an objective of measuring an individual contract rather than a group of contracts. There was also discussion about how prescriptive or detailed the guidance should be in determining the relevant level of aggregation, versus keeping a higher level focus on the outcome of having an appropriate CSM balance at the end of the period, reflecting remaining future service.

A number of Board members pointed out the need for judgement in determining contracts deemed to respond in 'similar ways' to changes in key assumptions or that have 'similar expected profitability', and also the usefulness of providing more guidance. These Board members expect that seeking input from external parties will give an indication of the level of further guidance needed, and a clearer view on the extent of offsetting of profitable and non-profitable contracts.

The Board recognised that this decision on the level of aggregation may well result in more granular measurement than most preparers apply as part of their existing accounting, but also noted the proposed guidance on the level of aggregation was already more generous in this regard than standards for other industries such as banking or retail, and that better accounting practices should lead to better business practices.

11 Board members were in favour, three disagreed.

How we see it

An objective of measuring CSM at the level of a group of contracts will be seen as a positive step by the insurance industry. However, the Board acknowledged that the way in which the principle's similar response to changes in key assumptions' and 'similar profitability' will be interpreted and applied in practice is of critical importance. Based on comments made during the meeting, it appears the Board accepts that this will be open to judgement. The Board plans to test this matter as part of its outreach activities.

CSM adjustment for contracts without direct participation features

The Board agreed on amending the guidance on the treatment of changes in the carrying amount of the CSM for insurance contracts without direct participation features (i.e., contracts accounted for under the general model), subject to further drafting improvements. The guidance relates to the treatment of experience adjustments. An experience adjustment is defined as the effect of differences between previous assumptions and what has actually happened.

The revised guidance will clarify further which changes adjust the CSM and which would not, maintaining the objective of distinguishing changes relating to future service from changes relating to current or past service.

Under this revised guidance:

- The CSM requires an adjustment for experience adjustments and changes in estimates of the present value of future cash flows that relate to future coverage or other services.
- The CSM is not adjusted for an experience adjustment or a change in the present value of future cash flows caused by changes in financial assumptions (being the effect, if any,

[1] The IASB's website also provides information about the tentative decisions taken on the Exposure Draft *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* to amend IFRS 4 to mitigate the impacts of IFRS 9 for insurers: http://www.ifrs.org/Current-Projects/IASB-Projects/Different-effective-dates-of-IFRS-9-Financial-Instruments-and-the-new-insurance-contracts-Standard/Pages/default.aspx.

on estimated future cash flows and the effect of a change in discount rate) because these are not regarded as being related to future service.

- In identifying whether experience adjustments and changes in estimates of future cash flows relate to future services, a company should regard experience adjustments as relating to current or past services and changes in estimates of future cash flows as relating to future services. However, the circumstances where this does not apply, include: (a) the effect of events that result in an experience adjustment causes a change in estimates of future cash flows (in which case, the combined effect would be regarded as relating to future service); or (b) the effect causes changes in estimates of incurred claims (which would be regarded as all relating to current or past service).

During the Board meeting, there was particular focus and discussion on how best to define and exemplify experience adjustments for determining what part should be taken to profit or loss (P&L) and what part adjusted the CSM. The Board discussed a number of events that could cause changes in current period experience and/or represent indicators of future assumption changes (such as increased consultant costs for medical claims). The Board also discussed events where the timing of an expected event has been delayed or happened earlier than expected (such as a death or lapses) and as such may affect current year experience as well as cause a change in expected future cash flows.

The Board asked the staff to continue to consider drafting improvements that would help preparers in differentiating between events that have a cause and effect between a current/past event and future assumptions, and those that do not.

12 Board members voted in favour and two against.

How we see it

The Board decided to distinguish between experience adjustments that relate to future services, which should adjust the CSM and those which relate to current or past service, that are recognised immediately in P&L. We believe the Board will need to provide more guidance on how to make this distinction in order to achieve consistent application, for example, by clarifying when an event that results in an experience adjustment would cause a change in expected future cash flows.

Presentation and disclosure of insurance finance income or expenses

The Board agreed with the staff that an entity should have an accounting policy choice on whether to disaggregate the change in the risk adjustment into a finance component and an underwriting component. An entity choosing not to disaggregate should present the entire change in the risk adjustment as part of the underwriting result.

The Board decided that this would be an accounting policy choice, and consequently subject to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requirements on selection and disclosure of an accounting policy.

An entity may choose to disaggregate insurance finance income or expenses between P&L and other comprehensive income (OCI) for contracts that are not eligible for the current period book yield approach.[2] The objective of disaggregating insurance finance income or expenses is to present, in P&L, a systematic allocation of the total expected insurance finance income or expenses over the life of a contract. The standard will include guidance on systematic allocation and limit the choices of how this can be determined.

This decision amends the previous drafting which had an objective of presenting insurance finance income or expenses in P&L on a cost measurement basis.

The Board asked the staff to develop wording during drafting to ensure a limited and closed list of choices for contracts with participation features rather than just examples of how to allocate (and split between P&L and OCI) insurance finance income or expenses over the life of the contract. As such, the staff proposed the following guidance:

- For insurance contracts where a change in financial assumptions does not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rate(s) applicable at inception.
- For insurance contracts where changes in financial assumptions have a substantial effect on the amounts paid to the policyholder, a systematic allocation can be determined:
  i. Using a rate that allocates the remaining revised expected finance expenses over the remaining life of the contract at a constant rate

  Or

  ii. For contracts using a crediting rate to determine amounts due to the policyholder using an allocation based on amounts credited in the period and expected to be credited in future periods

The Board also agreed to amend disclosure requirements of insurance finance income or expenses, proposed by the staff in the following way:

- Remove the requirement to disclose a specified breakdown of total insurance finance income or expenses
- Include a requirement to explain the total amount of insurance finance income or expenses in a reporting period and combine this with requirements to:

[2] An entity would apply the same approach to contracts that are within the scope of the variable fee approach for direct participating contracts, but are not eligible for the current period book yield approach.

i. Highlight the relationship between insurance finance income or expenses and investment return on the related assets the entity holds in order to provide investors with sufficient information for them to understand the sources of net financial income or expenses in the statement of profit or loss and other comprehensive income

ii. Disclose an explanation of the methods that the entity uses to calculate the information presented in P&L

12 Board members were in favour, with two against.

How we see it

Many insurers will welcome the Board's decision to adopt an accounting policy choice on disaggregation changes in the measurement of a risk adjustment into a finance component and an underwriting component. Isolating a finance component may be seen as unnecessary when remeasuring the risk adjustment.

The Board has added restrictions to what it means to present expected insurance finance income or expenses in P&L on a systematic basis, i.e., the method may only be based on factors that affect the cash flows of the contract, the examples of methods applicable for contracts with participating features is now a closed list. Some insurers had expressed their agreement with the previous, more flexible, approach.

Reinsurance contracts and the scope of the variable fee approach

The staff asked the Board to clarify the scope of the variable fee approach as the current draft wording could be taken as capturing reinsurance contracts issued or held.

For reinsurance contracts issued, the staff explained the intention was not to capture reinsurance contracts in the variable fee approach, as this should only capture contracts where the entity earns fee for providing investment management type services. In reinsurance contracts issued, the reinsurer does not earn this sort of fee; rather it earns a compensation for providing reinsurance coverage, so should not be in scope.

For reinsurance contracts held, no variable fee compensation is earned in the view of the staff. Rather, the entity is paying for an insurance coverage service so these contracts should not be captured by scope of variable fee approach.

The Board unanimously agreed that a company should not apply the variable fee approach to reinsurance contracts issued or reinsurance contracts held.

How we see it

The Board decided that an entity should not apply the variable fee approach to reinsurance contracts issued or reinsurance contracts held. Companies that issue insurance contracts that are eligible for the variable fee approach, and reinsure these contracts, may experience an accounting mismatch if they cannot apply the variable fee approach to the relevant reinsurance contracts.

What's next?

The IASB staff will reflect these tentative decisions as it continues to work on a revised working draft of the standard and use that draft as a basis for seeking input from selected external parties on certain aspects. The Board expects to discuss further sweep issues that arise from testing and from the continued drafting process in the third quarter of 2016. At that time, the Board also aims to decide on a mandatory effective date for the standard.

In parallel, since the Board provided the staff with permission to begin the balloting process for the amendments to IFRS 4 regarding the application of IFRS 9, the joint aim of the staff and the Board remains to issue final amendments to the existing IFRS 4 by September 2016.

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