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In December, the IASB discussed the residual margin and impairment of reinsurance contracts held by an insurer.



## Moving towards global insurance accounting

This edition of *IFRS Newsletter: Insurance* highlights the results of the IASB-only discussions in December 2012 on the joint insurance contracts project. In addition, it provides the current status of the project and an expected timeline for completion.

### Highlights

- The residual margin would be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services.
- The residual margin for participating contracts would not be adjusted for changes in the value of the underlying items as measured using IFRS.
- At inception, a cedant would determine the residual margin on a reinsurance contract by reflecting in the expected fulfilment cash flows all the effects of non-performance, including those associated with expected credit losses. Subsequent changes in expected cash flows resulting from changes in expected credit losses would be recognised in profit or loss.

# DECEMBER ACTIVITIES

## What happened in December?

At this month's IASB-only meetings, the IASB discussed the following topics:

- residual margin; and
- impairment of reinsurance contracts held by an insurer.

One of the remaining issues left for the IASB to discuss before its deliberations come to a close is the measurement and allocation of the residual margin, with an emphasis on participating contracts.

The IASB refined its previous tentative decision on the unlocking of the residual margin recognised under the building-block approach, to address concerns about accounting for certain changes in estimates. The IASB decided that, instead of distinguishing between past and future cash flows, the requirements would distinguish between past and future coverage, and between investment and service components.

In addition, the IASB discussed industry proposals relating to the residual margin for participating contracts. Some preparers proposed a 'floating residual margin' for adjusting and allocating the residual margin for participating contracts. The IASB staff recommended a variation of the floating residual margin, but for different reasons. They recommended that the residual margin should be adjusted by the gains or losses arising from changes in the value of the underlying items that could potentially be attributable to the insurer. Consequently, there would be no accretion of the residual margin for participating contracts. The IASB had mixed views on the staff's recommendation; ultimately, by a slim majority, the IASB confirmed its previous decisions on the residual margin and decided that the residual margin for participating contracts would not be adjusted for changes in the value of the underlying items.

The IASB also considered how its tentative decisions in the impairment project would be applied to reinsurance assets. Under the IASB's redeliberations of the 2010 exposure draft (2010 ED), a cedant would apply the impairment model that is being developed for IFRS 9 *Financial Instruments* in measuring reinsurance assets. Due to some of the challenges involved in applying the tentative impairment model to reinsurance assets, the IASB decided that a cedant would not apply it; instead, the cedant would treat expected credit losses in the same way as other changes in the expected fulfilment cash flows. At inception of the contract, a cedant would determine the residual margin by reflecting in the expected fulfilment cash flows all the effects of non-performance by the reinsurer, including those associated with expected credit losses. The IASB also decided that subsequent changes in expected credit losses would be recognised in profit or loss.

In December, no joint or FASB-only meetings took place. The FASB plans to resume discussions on the insurance project in January 2013.

The Boards have a few sweep issues to deliberate before finalising their proposals.

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# UNLOCKING THE RESIDUAL MARGIN

**The residual margin would be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services.**

## What's the issue?

The IASB had previously decided to adjust the residual margin for changes in estimates of future cash flows – i.e. unlocking the residual margin. This tentative decision distinguished between:

- *past* cash flows – where experience adjustments are recognised immediately in profit or loss; and
- *future* cash flows – where changes in estimates of future cash flows are added to or deducted from the residual margin, and recognised in profit or loss in future periods, when the residual margin is released to profit.

The IASB staff identified a number of unintended consequences from this decision, as discussed in IASB staff paper 2A *Unlocking the residual margin*.

Changes in estimates	Treatment according to IASB's unlocking decision	Unintended consequences identified by IASB staff
<b>Incurred claims</b>	Changes in estimates of the amounts required to settle claims incurred in current or previous periods are changes in estimates of future cash flows. Such changes would be offset against the residual margin.	These changes relate to coverage already provided and not to future coverage and, as such, should be recognised immediately in profit or loss.
<b>Experience differences in premium receipts</b>	Higher-than-expected lapse rates result in lower-than-expected income in the current period, but may also result in lower-than-expected claims in future periods. The reduction in income represents an experience difference that would be recognised immediately in profit or loss. In contrast, the reduction in future claims represents a change in estimate of future cash flows that would be added to the residual margin.	There may be a mismatch between: <ul style="list-style-type: none"><li>• the timing of the loss (recognised immediately); and</li><li>• the related gain (recognised over the remaining contract term).</li></ul>
<b>Repayments of investment components</b>	Actual repayments from an investment component of an insurance contract may differ from previous estimates. Fewer repayments in the current period are likely to result in more repayments in later periods. The reduction in repayments in the current period represents an experience difference that would be recognised as an immediate gain. By contrast, the increased future repayments represent a change in estimate of future cash flows that would be offset against the residual margin.	A delay in repaying an investment component should not give rise to: <ul style="list-style-type: none"><li>• a gain in the current period; and</li><li>• a loss in a future period.</li></ul>

Changes in estimates	Treatment according to IASB's unlocking decision	Unintended consequences identified by IASB staff
<b>Contracts with asset-dependent cash outflows</b>	<p>Higher-than-expected asset gains in the current year may result in higher estimates of cash outflows in future periods. The increase in estimates of future cash flows would be offset against the residual margin.</p>	<p>The increase relates to asset gains in the current period, and does not indicate reduced profitability in future periods.</p> <p>In addition, for asset-dependent cash flows, a mismatch may arise between:</p> <ul style="list-style-type: none"> <li>the recognition of the higher-than-expected asset returns; and</li> <li>the recognition of the increased future outflows to policyholders.</li> </ul>

### What did the staff recommend?

The IASB staff thought that, to avoid these unintended consequences, cash flows should be distinguished on a different basis for determining when the residual margin should be unlocked. They thought that this distinction should be between past and future coverage, and between investment and service components – rather than between solely past and future cash flows.

As a result, the staff recommended that the residual margin would be unlocked for differences between current and previous estimates of cash flows relating to *future coverage or other future services*.

In applying this refined notion:

- changes in estimates of incurred claims would be recognised in profit or loss;
- the residual margin would be adjusted for experience differences if they relate to future coverage – e.g. premiums received for future coverage;
- a delay or acceleration in repayments of investment components would not necessarily lead to the residual margin being adjusted; and
- the residual margin for contracts with asset-dependent cash flows would be adjusted only for changes in estimates of profit for *future services*. Changes in the profits for services in the current period would be recognised in profit or loss immediately. If such changes related to contracts to which mirroring is applied, then the changes would be recognised and presented in a way that mirrored the recognition of asset gains or losses.

### What did the IASB discuss?

Most of the IASB members agreed with the staff recommendation. One Board member thought that further explanation of the rationale for the change should be included in the basis for conclusions. This member also asked whether the staff had received feedback from insurers on the proposed changes. The staff noted that some insurers had been consulted, but that wide-ranging outreach had not been performed.

### What did the IASB decide?

The IASB agreed with the staff recommendation.

# RESIDUAL MARGIN FOR PARTICIPATING CONTRACTS

**The residual margin for participating contracts would not be adjusted for changes in the value of the underlying items.**

## Unlocking the residual margin for participating contracts

### What's the issue?

Many view the residual margin as the unearned profit on the insurance contract. Consequently, one reason for unlocking the residual margin for changes in future cash flows would be to depict a current view of the unearned profit of the contract.

Under the IASB's tentative decisions:

- the residual margin would be adjusted for the effects of the time value of money by accreting interest on the margin using the discount rate at inception; and
- the residual margin would be unlocked or adjusted for differences between current and previous estimates of cash flows relating to future coverage or other future services.

For participating contracts, some constituents support unlocking the residual margin for gains and losses arising from underlying items – e.g. assets or underlying experience – when those gains and losses are not regarded as having been earned in the period. This approach is referred to as a 'floating residual margin'.

Under participating contracts, policyholders share with insurers the returns of a pool of assets over the contract duration; they receive returns in the form of bonuses at different intervals over the term of the contract. When applying a floating residual margin, the unearned profit in the contract would represent the difference between:

- the cumulative level of investment returns on assets (including the insurer's share of those returns); and
- the cumulative level of returns allocated to the policyholders.

In effect, any gains or losses of the contract (including those stemming from options and guarantees) would be treated as unearned until they are declared as a bonus – i.e. distributed to policyholders. The proposal would reflect the insurer's share in the performance of the underlying items in the margin until a dividend is declared.

The IASB staff paper considers whether a floating residual margin approach should be applied to participating contracts under the proposed model for insurance contracts.

### What did the staff recommend?

The IASB staff made the following observations.

- Participating contracts have a contractual link between the contract and underlying items. For these contracts, the value of the linked items may serve as a proxy for the updated value of the premiums.
- The IASB staff considered the floating residual margin approach for participating contracts to be similar to remeasuring the premiums used to determine the margin.
- Applying the IASB's tentative decisions may result in accounting mismatches when the margin is accreted using a discount rate at inception and the underlying items are measured at fair value.

Instead of accreting the residual margin of participating contracts at the discount rate at inception, the IASB staff recommended a variant of the floating residual margin approach; under this variant, the residual margin would be adjusted by the gains or losses arising from the changes in the value of the underlying items that could potentially be attributable to the insurer.

The staff presented examples comparing the floating residual margin approach to the IASB's tentative decisions to date and the IASB staff recommendation.

## Illustrative example of the residual margin for participating contracts under the different approaches<sup>1</sup>

Consider a discretionary 90/10 participating contract with no guarantees.

### Fact pattern

- The insurer receives premiums to purchase assets of 1,000.
- The policyholder participates in 90% and the insurer in 10% of the asset returns.
- The present value of the cash outflows is 900 and the margin is 100.

At the end of the year:

- management declares a bonus of 90 to the policyholders, while the insurer's share is 4 (total bonuses declared are 94); and
- the value of the underlying assets has increased to 1,100 (an increase of 100).

### Analysis

Under the Boards' mirroring decisions, the insurance liability would be increased by 90 (90% of the increase in the underlying assets). Interest is accrued on the margin at 5% and therefore by 5. The residual margin allocated according to the services provided is 3. The net profit reported would consist of:

- the insurer's potential share of the 10% share of the investment income; less
- the interest accrued; plus
- the amount of the margin release, according to the services provided.

Under the floating margin approach, gains potentially attributable to the insurer of 10 (being investment income less the policyholder's share in investment income, or 100 - 90) would be adjusted against the residual margin. An amount of 4 would be released from the margin, representing the insurer's share in the bonus declared. Under this approach, the net profit recognised would be equal to the insurer's share of the bonuses declared.

Under the staff recommendation, gains of 10 that could potentially be attributable to the insurer would also be adjusted against the residual margin; however, 3 would be released from the residual margin. The net profit recognised would be equal to the allocation of the residual margin, according to the services provided.

The profit or loss for the period for the different approaches would be as follows.

	IASB's residual margin	Floating residual margin	Staff recommendation
Investment income	100	100	100
Interest expense (expected cash outflows)	(90)	(90)	(90)
Interest expense (accretion of margin)	(5)	-	-
Remeasurement of margin	-	(10)	(10)
Release of margin	3	4	3
<b>Net profit</b>	<b>8</b>	<b>4</b>	<b>3</b>

<sup>1</sup> This example has been adapted from the December staff paper 2B *Proposals relating to the margin for participating contracts*.

**The constraint on recognising revenue proposed in the revenue recognition project would not be applied to the allocation of the residual margin.**

## What did the IASB discuss?

There were mixed views on the staff recommendation. Some Board members did not think that the profit or loss on the insurer's share of the underlying assets should be delayed and recognised in future periods. In addition, some Board members did not think that the change in asset value should drive the amount of profit being recognised under the contract.

Other Board members did not support the staff recommendation because they thought it introduced an element of 'smoothing' profit or loss, since it delayed until future periods the recognition of changes in cash flows related to the insurer's share of the contract's results. In addition, some Board members commented that the staff recommendation would be more complicated when the mirroring proposals did not apply.

Some Board members supported the staff recommendation, because they thought that this approach:

- was consistent with the proposals in the revenue recognition project; and
- allocated the margin based on the services provided.

Those Board members supporting the staff recommendation did not think that an insurer could determine whether profits were 'earned' in any given period, because the insurer's share of the results under the contract:

- could not easily be derived in any given period; and
- was an amalgamation of several estimates.

## What did the IASB decide?

The IASB did not agree with the IASB staff recommendation by a slim majority (eight to seven). It decided that, for participating contracts, the residual margin would not be adjusted for changes in the value of the underlying items as measured using IFRS.

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## Allocating the residual margin

### What's the issue?

According to the IASB's tentative decisions, the residual margin would be allocated over the coverage period on a systematic basis, consistent with the pattern of transfer of the services provided under the contract. Under the IASB's 2011 exposure draft *Revenue from Contracts with Customers*, a constraint would apply to the cumulative amount of revenue recognised if the amount of consideration that an entity expects to receive is variable. Revenue in this circumstance would be limited to the amount an entity is 'reasonably assured' to be entitled to.

### What did the staff recommend?

For participating contracts, those supporting the allocation of the residual margin based on the performance-sharing mechanism argued that the mechanism is consistent with the proposal in the revenue recognition project to constrain revenue to amounts that are 'reasonably assured'. The constraint would apply if the amount of consideration to which an entity expects to be entitled were variable.

The IASB staff noted that for some participating contracts a performance-sharing mechanism may be appropriate. However, the performance-sharing mechanism may not reflect the pattern of services provided under the contract – for example, when:

- bonuses are highly regulated or are declared on a prudent basis; or

- the major distributions of the asset returns occur on maturity of the contract.

In applying the constraint in the revenue recognition project to insurance contracts with variable consideration, the IASB staff believes that an insurer would release the margin only on termination or maturity of the contract.

The staff believed that it would be inconsistent to recognise profit on a reasonably assured basis when the measurement of the unearned profit – i.e. the residual margin – is determined on an expected present value basis. The staff also argued that constraining the allocation of the residual margin using the revenue recognition proposals would be inconsistent with the recognition of changes in the risk adjustments. The IASB has previously agreed to recognise gains resulting from changes in the risk adjustment in profit or loss, even though those gains may reverse in a future period.

The IASB staff therefore recommended that the revenue recognition guidance on constraints would not be applied to the allocation of the residual margin for all insurance contracts.

### **What did the IASB decide?**

The IASB agreed with the staff recommendation.

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# IMPAIRMENT OF REINSURANCE CONTRACTS HELD BY AN INSURER

**At inception, a cedant would determine the residual margin by reflecting in the expected fulfilment cash flows all expected effects of non-performance.**

**Subsequent changes in expected credit losses would be recognised in profit or loss.**

## What's the issue?

In previous meetings, the IASB tentatively confirmed its proposals that would require a cedant to apply the impairment model being developed for IFRS 9 *Financial Instruments* to reinsurance assets. Several respondents to the 2010 ED had agreed that an expected loss model consistent with the model being developed in the financial instruments project should be applied to reinsurance contracts. However, since receiving this feedback, the IASB has made tentative changes to the treatment of reinsurance under the insurance proposals, and has also refined its tentative impairment model for financial instruments. The IASB staff paper considers how, in light of these subsequent changes, an insurer would recognise credit losses for reinsurance assets.

The IASB staff noted that, in applying the tentative changes, an inconsistency would arise between the recognition and measurement of expected credit losses and other future cash flows under the reinsurance contract, for the following reasons.

- Under the revised proposals, an insurer measures the present value of fulfilment cash flows in the same way as the corresponding portion of the fulfilment cash flows of the underlying contract – except that the fulfilment cash flows under the reinsurance contract would also include an estimate of expected credit losses of the reinsurer. The cedant would recognise a residual margin for any resulting day one gain or loss on the reinsurance contract. This residual margin would be unlocked for both favourable and unfavourable changes in future cash flows. As a result, changes in future cash flows would not be recognised in profit or loss.
- In applying the revised impairment proposals, the cedant would:
  - determine the initial and subsequent expected credit losses of reinsurance assets at inception, using the impairment model being developed under the financial instruments project;
  - recognise a portion of those expected credit losses – i.e. the 12-month expected loss – in profit or loss when the reinsurance contract is recognised; and
  - in subsequent periods, recognise changes in the expected credit losses in profit or loss.

## What did the staff recommend?

The IASB staff considered two alternatives for the treatment of expected credit losses for reinsurance assets.

<b>Alternative 1</b>	<b>Apply the requirements of the insurance contracts decisions</b> A cedant would account for expected credit losses in the same way as other changes in the expected fulfilment cash flows; and accordingly would not apply the proposals for impairment of financial assets being developed by the IASB. The residual margin would be adjusted for changes in expected credit losses in future periods.
<b>Alternative 2</b>	<b>Apply the requirements of the IFRS 9 impairment decisions</b> At initial recognition of the reinsurance contract, a portion of the initial estimate – i.e. the 12-month expected loss – would be recognised in profit or loss. Subsequent changes in estimates of expected credit losses would be recognised in profit or loss, as required by the impairment model.

The IASB staff supported Alternative 1, for the following reasons.

- Unlocking the residual margin for changes in expected credit losses would enable the insurer to consistently measure the unearned profit in the contract. The residual margin would reflect the difference between the premium in the contract and an updated measure of the present value of fulfilment cash flows – both at inception and in subsequent periods.
- The measurement principle for the reinsurance contract should be applied regardless of the reasons for which the specific cash flows arise. As a result, requiring different treatments for initial estimates and subsequent changes in expected credit losses would not be consistent with that principle.
- The impairment model applies to the initial estimate and subsequent changes in expected credit losses – but not to cash flows arising from other causes of non-performance, such as disputes. Applying different accounting to different causes of non-performance would result in inconsistency.
- Under the insurance contract proposals, reinsurance contracts are measured on a current expected value basis, which includes expected credit losses.

### **What did the IASB discuss?**

Many Board members agreed that the insurance model (rather than the impairment model) should be applied when estimating expected credit losses under a reinsurance contract. However, they expressed concerns with the subsequent treatment of expected credit losses under the staff recommendation, for the following reasons.

- The reinsurance asset would not be adjusted in the same period in which the credit deterioration occurs. Several Board members thought that reductions in the amounts an insurer expected to receive under a reinsurance contract as a result of deteriorating credit should:
  - be reflected when these estimates change; and
  - be transparent in the financial statements.
- Although many Board members agreed that a day one loss under a reinsurance contract would reflect the cost of service of reinsurance, they did not agree that subsequent changes in credit risk would be included as part of that service.
- Several Board members thought that there was a distinction between expected credit losses and other cash flows under the reinsurance contract. Changes in cash flows under the reinsurance contract typically mirror the changes in cash flows on the underlying direct contract. They agreed that changes in the 'mirrored' future cash flows should be unlocked against the residual margin consistent with the underlying contract. However, they thought since credit risk only applies to the reinsurance asset it warranted a different treatment.
- Several Board members agreed that, when the amounts the insurer expects to collect under the reinsurance contract decrease due to credit risk, this should be reflected in profit or loss immediately.

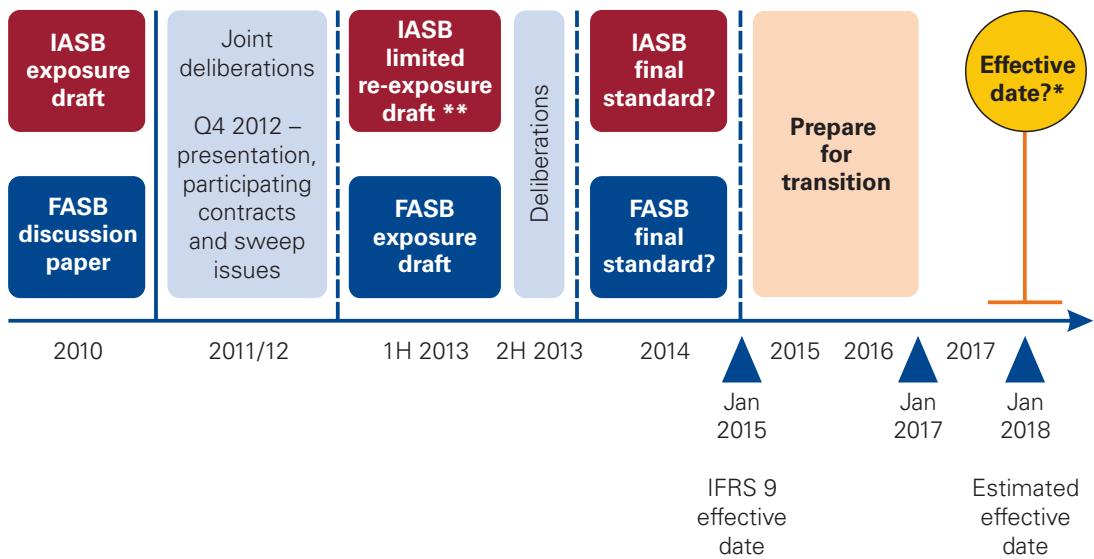
### **What did the IASB decide?**

The IASB decided that:

- at inception of a reinsurance contract, a cedant would determine the residual margin by reflecting in the expected fulfilment cash flows all the effects of non-performance, including those associated with expected credit losses; and
- subsequent changes in cash flows that result from changes in expected credit losses would be recognised in profit or loss.

# TIMELINE FOR COMPLETION

Based on the IASB's published workplan, a limited re-exposure document from the IASB is expected in the first half of 2013. We anticipate similar timing for the FASB's ED. A final standard is not anticipated before 2014.



\* The effective date of the final IFRS is expected to be approximately three years after the standard is issued. The IASB staff currently estimates that the issue date will be mid to late 2014 – which, on this basis, would result in an expected effective date of annual reporting periods beginning on or after 1 January 2018.

\*\* The limited re-exposure by the IASB is expected to include questions on the proposals relating to the following issues.

- The requirement that the cash flows used to measure participating contracts be based on the cash flows used to account for the underlying items – i.e. the mirroring approach.
- The requirement to present premiums in the statement of comprehensive income, including the requirements that:
  - the part of the premium that relates to investment components be excluded from the premium presented in the statement of comprehensive income; and
  - the premiums be allocated in the statement of comprehensive income on an earned basis.
- The requirement to use the residual margin to offset changes in estimates of future cash flows – i.e. unlocking of the residual margin.
- The requirement to present in OCI the effect of changes in the discount rate used to measure the insurance contract liability.
- The revised transition proposals.

Significant differences between the IASB and FASB models that are likely to be carried forward into the published proposals include:

- three vs four building blocks in measurement (the IASB's model includes a risk adjustment);
- unlocking vs locked-in margins;
- the consideration of successful vs unsuccessful sales efforts in acquisition costs; and
- the scope of investment contracts with a discretionary participation feature.

# FIND OUT MORE



For more information on the project, including our publications on the 2010 ED, *New on the Horizon: Insurance, The New World for Insurance: Business perspectives on Phase II* and *The New World for Insurance: Progress report on Phase II*, see our [website](#).

The [IASB's website](#) and the [FASB's website](#) contain summaries of the Boards' meetings, meeting materials, project summaries and status updates.

Visit KPMG's *Global IFRS Institute* at [kpmg.com/ifrs](http://kpmg.com/ifrs) to access KPMG's most recent publications on the IASB's major projects and other activities. Recent publications that are relevant to the insurance project include:

- [New on the Horizon: Classification and Measurement – Proposed limited amendments to IFRS 9 \(December 2012\)](#)
- [IFRS Newsletter: Financial Instruments – Issue 8 \(December 2012\)](#).

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