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KPMG
cutting through complexity

"The staff proposals respond to the concerns of many constituents and may facilitate finalisation of the project."

Joachim Kölschbach,
KPMG's global IFRS insurance leader

MOVING TOWARDS INTERNATIONAL INSURANCE ACCOUNTING

This special edition of *IFRS Newsletter: Insurance* highlights the IASB's discussions in the March 2015 education session on its insurance contracts project.

Highlights

The IASB continues to consider whether, and in what circumstances, adaptations are needed to the general insurance contracts model to accommodate contracts with participating features. This month's meeting was an education session to discuss the following key issues identified in previous education sessions, and the staff did not ask for any decisions.

- Should the contractual service margin (CSM) be adjusted ('unlocked') to reflect changes in an entity's share of underlying items? If so, then how and for which contracts?
- How should the CSM be recognised in profit or loss?
- How should an entity determine interest expense to be presented in profit or loss or, if it is permitted, in other comprehensive income (OCI)?

The meeting also followed up on the 'alternative proposals' presented by the European CFO Forum in November 2014. For each question above, this newsletter summarises the staff recommendations and discussions with Board members, and highlights key differences from the Forum's alternative proposals.

Expected timeline

The Board will continue these discussions over the next few months. We currently expect it to complete its redeliberations in 2015 and a final standard to be released in early 2016.

ACCOUNTING FOR THE CSM

Should the CSM be unlocked to reflect changes in an entity's share of underlying items? If so, then how and for which contracts?

Unlocking the CSM

What's the issue?

For contracts with participating features, achieving faithful representation of an entity's interest in underlying items may require adaptations to the IASB's general insurance contracts model.

To further explore this concern, the staff distinguished between two possible ways of viewing an entity's interest in underlying items.

View	Description
A	The entity is considered to earn a variable fee in exchange for providing services – i.e. the contract creates an obligation to pay the policyholder an amount equal to the value of the underlying items, less the variable fee for service.
B	The entity is considered to share in the economic returns from underlying items.

What did the staff recommend?

The following table summarises the issues analysed by the staff and their recommendations.

Issue	View A	View B
Should the CSM be unlocked to reflect changes in an entity's share of underlying items? *For more detail, see Agenda Paper 2A.*	Yes; any benefits received by the entity arise only as a consequence of holding those items on behalf of the policyholder. The entity's financial statements would report a net investment return – i.e. the difference between returns from investments and payments promised to the policyholder.	No; the entity's profit arises from the difference between the returns from investments and the payments that the entity makes to the policyholder out of those returns. The entity's investment portfolio would be accounted for in the same way as a stand-alone investment that the entity owns and controls.
If so, how? *For more detail, see Agenda Paper 2B.*	No adaptations are needed to the general approach for fulfilment cash flows or the CSM on initial recognition.	
	Subsequent to initial recognition, the CSM would be unlocked for changes in the expected: • net variable fee for service; and • present value of the cost of guarantees.	No adaptations are needed to the general approach for measuring the CSM subsequent to initial recognition.
	The rates used to determine the present values of adjustments to the CSM and to accrete interest on the CSM would be the current rates.	

Eligibility criteria

Because unlocking the CSM may result in a different accounting outcome subsequent to initial recognition, the staff also proposed eligibility criteria. View A would be appropriate when the following three criteria are met:

- the contract specifies that the policyholder participates in a clearly identified pool of underlying items;
- the entity expects a substantial proportion of cash flows from the contract to vary with changes in underlying items; and
- the entity expects the policyholder to receive an amount representing a substantial share of the returns from underlying items.

After initial recognition, there would be no requirement to reassess the eligibility criteria and the staff noted that, excluding some universal life contracts, many participating contracts – e.g. unit-linked, European 90-10 and index-linked contracts – are expected to meet the eligibility criteria.

What did the IASB discuss?

Some Board members appeared to see some merit in View A. However, there were concerns expressed, including the following.

- If options and guarantees are not separated from an insurance contract (e.g. minimum interest guarantees), then:
  - economic mismatches would be reflected in the CSM, rather than recognised in profit or loss; and
  - entities that hedge these exposures may have an accounting mismatch caused by changes in the fair value of derivatives being recognised in profit or loss.
- Increased judgement and lack of comparability would be introduced within the criteria by the terms 'substantial proportion' and 'substantial share'.

Two Board members suggested that the staff consider the proposal to use current rates for determining the present value of the amounts that adjust the CSM and for determining the accretion of interest in the context of non-participating contracts.

How does this compare with the Forum's alternative proposals?

The approach recommended by the staff has some similarities to the Forum's alternative proposals, except that the staff's proposals:

- are narrower in scope than the Forum's – e.g. the staff's eligibility criteria may exclude some universal life contracts; and
- would unlock the CSM only for cash flows promised to the policyholder that arise from the underlying items specified in the contract, as opposed to projected future allocation of returns from specified items that the entity holds.

How should the CSM be recognised in profit or loss?

Recognising the CSM in profit or loss

What's the issue?

All insurance contracts provide insurance coverage; therefore, the staff believe that the IASB's conclusions on the pattern of delivery of insurance coverage (i.e. that insurance coverage is provided on the basis of the passage of time and varies with the expected number of contracts in force) apply equally to contracts with participating features.

However, most insurance contracts with participating features also provide investment-related services in addition to insurance coverage. As a result, a question then arises over the appropriate methodology for recognising the CSM in profit or loss.

What did the staff recommend?

The staff believed that only View A (discussed previously) considers both investment-related services and insurance coverage.

Applying the principle that the CSM should be recognised in profit or loss in a systematic way to reflect the transfer of services provided under an insurance contract, the following questions arise.

Question	Staff's view
What is the pattern of delivery of the investment-related service?	It could be considered to be governed by a combination of: • the passage of time; and • the amount of assets (or underlying items) under management.
How should the CSM be recognised if more than one service is provided?	The staff outlined the advantages and disadvantages of using multiple drivers or a single driver (e.g. predominant cash flow) and asked the Board for direction.

For more detail, see Agenda Paper 2C.

What did the IASB discuss?

The Board members acknowledged the difficulties in prescribing appropriate methodologies for recognising the CSM in profit or loss – e.g. how to reflect highly inter-related services with different patterns of provision in the allocation pattern for the CSM as a whole or, if using the predominant cash flow approach, how to respond to changes over time.

Although a few Board members seemed persuaded by the simplicity and understandability resulting from a single driver (e.g. predominant cash flow), as well as recognising the CSM on the basis of the passage of time, at least one noted that he was 'uncomfortable' with the approach because it would mean recognising more profit earlier in the contract life than would be recognised under IFRS 15 *Revenue from Contracts with Customers*.

How does this compare with the Forum's alternative proposals?

The Forum agreed with the IASB's principle that the CSM would be recognised in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the contract. However, whereas the Forum's alternative proposals maintained a strictly principles-based approach, the staff believed that the IASB would need to provide further guidance on how the principles should be applied.

DETERMINING INTEREST EXPENSE

How should an entity determine the interest expense to be presented in profit or loss or, if it is permitted, in OCI?

Using OCI to present the effects of changes in discount rates

What's the issue?

For non-participating contracts, the IASB allows entities an accounting policy choice to present interest expense in profit or loss using the locked-in rate at inception of the contract. The difference between the interest expense recognised in profit or loss (e.g. the locked-in rate) and the interest expense consistent with the balance sheet measurement would be recognised in OCI (the OCI approach). Alternatively, an entity may elect to present the effects of changes in discount rates in profit or loss.

For participating contracts, the IASB has yet to determine whether to permit, or require, the OCI approach and, if so, how to determine the interest expense to be presented in profit or loss, or in OCI.

What did the staff recommend?

Assuming that the IASB decides to permit, or require, the OCI approach for participating contracts, the staff proposed the following approaches.

Approach	Criteria for application
Effective yield	The cash flows in the contract that vary with the returns on underlying items are a substantial portion of the total benefits to the policyholder over the life of the contract.
Current period book yield	The entity: • has an obligation to pay the policyholder an amount equal to the value of the underlying items less the variable fee for service – i.e. the criteria for unlocking the CSM are met; and • holds the underlying items, either through choice or because it is required to.

The staff acknowledged that if the Board decides to adopt an effective yield approach, then further consideration would need to be given to the 'level yield' and 'projected crediting' variations discussed in September 2014 (see Issue 43 of *IFRS Newsletter: Insurance*), as well as proposed modifications to those variations.

What did the IASB decide?

There was general support for the staff's proposals, but one Board member questioned the appropriateness of the term 'interest expense' because mirroring investment returns may result in a gain – i.e. when there is a loss on the underlying items.

How does this compare with the Forum's alternative proposals?

Although the current book yield approach proposed by the staff is not a yield on assets, but is a result of mirroring the amounts reported in profit or loss for the underlying items, the Forum's alternative proposals may produce a similar outcome.

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You can also go to the insurance pages on the IASB website.

Visit KPMG's *Global IFRS Institute* at kpmg.com/ifrs to access KPMG's most recent publications on the IASB's major projects and other activities.

Financial instruments

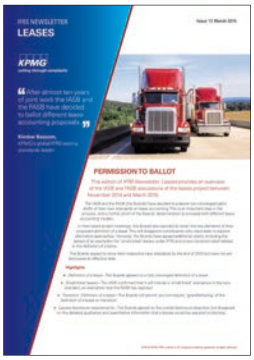
Our IFRS – financial instruments hot topics page brings together our materials on the complete version of IFRS 9 published in July 2014.

Our *IFRS Newsletter: Financial Instruments* examines the latest developments on the financial instruments project – including the IASB's ongoing discussions on macro hedge accounting.

Revenue

Our IFRS – revenue hot topics page brings together our materials on the new revenue standard. Our *Issues In-Depth* provides more detailed analysis and observations while our *IFRS Newsletter: Revenue* examines the latest developments on the standard.

Leases



Our IFRS – leases hot topics page brings together our materials on the leases project, including our *IFRS Newsletter: Leases* and our suite of publications on the IASB's re-exposure draft on lease accounting published in May 2013.

IFRS Breaking News

Our IFRS Breaking News page brings you the latest need-to-know information on international standards in the accounting, audit and regulatory space.

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