

Practical guide to IFRS

*Revised exposure draft will
significantly change accounting
for insurance contracts*

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Introduction

On 20 June 2013, the IASB ('the Board') published a revised exposure draft (ED) on the accounting for insurance contracts reflecting its response to the comments received on the 2010 ED ('previous ED'). The comprehensive proposals will fundamentally change the accounting by insurers and other entities that issue insurance contracts. The Board has attempted to address the concerns of constituents regarding the perceived 'artificial' volatility caused by the proposals in the previous ED, but these changes add complexity. The proposed standard will replace IFRS 4, which currently permits a wide variety of accounting practices for insurance contracts.

This practical guide summarises the key proposals and their implications. Appendix 1 compares these proposals with the previous ED. Appendix 2 compares the proposals with the FASB ED that was issued on 27 June 2013. Appendix 4 provides a high-level comparison of the revised ED with Solvency II. The questions in the IASB ED target five key areas that have significantly changed since the previous ED as set out below:

- The use of other comprehensive income ('OCI') for changes in discount rates.
- Unlocking the contractual service margin (previously known as the residual margin).
- Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items.
- Presentation in the statement of comprehensive income.
- Transition.

It is important for insurers and other entities issuing insurance contracts to assess how all the requirements in the measurement model fit together. It will be critical for insurers to work closely with stakeholders to make sure that they understand the impact of the significant changes being proposed. This could be the last opportunity for the industry to influence the debate before the expected effective date of 2018. Insurers need to act now in assessing the implications of the new proposals on both their contracts and business practices and to assess the additional demands of the proposals on resources, data and modelling systems.

At a glance

- The proposals continue to require entities to measure their insurance contracts using a current measurement model, where current estimates are re-measured each reporting period.
- Consistent with the previous ED, the measurement approach is based on the building block approach of a current, discounted and probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract; an explicit risk adjustment and a contractual service margin.
- A simplified approach is permitted if the coverage period is one year or less or if the measurement provides a reasonable approximation to applying the building block approach.

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Background

The IASB has concluded its re-deliberations on the insurance contracts project. The Board has been working together with the FASB for several years on developing a comprehensive, converged standard on accounting for insurance contracts that addresses recognition, measurement, presentation and disclosure.

In 2010 the IASB issued an exposure draft and the FASB issued a discussion paper on the subject. Since early 2011 the IASB and FASB (‘the Boards’) have been re-deliberating the issues using comments received from constituents. Based on the differences in views expressed during the re-deliberations, it has become apparent that the Boards will likely not achieve a converged standard.

The comment period for the IASB as well as the FASB ends on 25 October 2013.

PwC observation

The IASB’s predecessor body initiated the development of a standard for insurance contracts in 1997. Due to delays, many insurers may have lost interest in the project. However, the IASB is determined to finalise this project. The proposed standard is an important opportunity to comment on the requirements before a final standard is issued.

The likely outcome of the IASB project is a comprehensive IFRS standard on insurance, while the ultimate result of the FASB project is less certain. This is because unlike U.S. GAAP, IFRS currently has no comprehensive insurance contracts standard. Therefore, despite the fact that the FASB exposure draft proposes an entirely new model for insurers, the FASB could ultimately decide to introduce only some of the proposed changes. The high-level differences between the IASB and FASB proposals are included in Appendix 2 to this practical guide.

Definition, scope and combining contracts

The proposals apply to all entities that issue insurance contracts, not just insurers. The proposals continue to define an insurance contract as “a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder”. The definition of an insurance contract has been clarified compared to current IFRS 4 to require the evaluation of insurance risk to be done using present values rather than absolute amounts. This is not specified in current IFRS 4, although most entities apply this new requirement already in practice. In addition, a contract does not transfer insurance risk if there is not a scenario with commercial substance in which the insurer could incur a loss.

The scope of the proposed standard includes insurance contracts that an entity issues. Insurance contracts that an entity holds as a policyholder are not in scope, although a cedant will apply the proposals to reinsurance contracts that it holds.

PwC observation

Current IFRS 4 allows a wide variety of accounting practices as entities are allowed to continue their previous practice from their local GAAP. Given the scope changes as set out below, many contracts issued by non-insurers will be outside of the scope of the proposed standard. Nevertheless, non-insurers should assess whether their contracts contain significant insurance risk and therefore are within the scope of the proposed standard.

PwC observation (continued)

The implementation guidance in current IFRS 4 will not be carried forward in the proposed standard. The Board thinks now that IFRS 4 has been in place for many years, there is less need for the implementation guidance. However, first-time adopters and other parties new to insurance accounting may have found the guidance useful.

Investment contracts with discretionary participation features are in scope of the proposed standard if the entity also issues insurance contracts, even though they are not insurance contracts. These are considered further in the section on contracts with cash flows that vary with returns on underlying items.

Financial guarantee contracts such as credit derivatives or mortgage guarantee insurance are not in scope, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. In this case the issuer can choose to apply the standards for financial instruments or the proposed standard for insurance contracts. The entity can make that election contract by contract, but the election for each contract is irrevocable.

PwC observation

The choice offered for financial guarantee contracts will enable both banks and insurers to account for these contracts in the way they view them within their business. However, consistent with current IFRS 4 it is unclear how entities that issue such contracts for the first time are required to account for financial guarantee contracts.

The Board has continued to exclude certain contracts that meet the definition of an insurance contract from the scope of the proposed standard. The scope exclusions carried forward from IFRS 4 include:

- Product warranties issued by a manufacturer, dealer or retailer.
- Contractual rights or contractual obligations that are contingent on the future use of, or the right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items).
- Employers' assets and liabilities under employee benefit plans.
- Residual value guarantees provided by a manufacturer, dealer or retailer as well as a lessee's residual value guarantees embedded in a finance lease.
- Contingent consideration payable or receivable in a business combination.

In addition, fixed-fee service contracts that provide services as their primary purpose, and that meet all of the following conditions are also excluded from the scope:

- The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;
- The contract compensates customers by providing a service, rather than by making cash payments; and
- The insurance risk that is transferred by the contract arises primarily from the customer's use of services.

PwC observation

The Board intends that many fixed-fee service contracts (such as roadside assistance contracts and repair services) are outside of the scope of the insurance contract proposals. Instead an entity has to apply the proposed standard for revenue from contracts with customers. The accounting under this proposed standard would generally not be very different from the proposed insurance contracts standard as the premium-allocation approach would apply to such contracts in most circumstances (which we discuss later in this practical guide).

The distinction between fixed-fee service contracts and insurance contracts can be complex to assess in practice. In the re-deliberations, certain fixed-fee service contracts were contrasted to show which contracts would meet the scope exclusion. For example, capitation agreements were discussed. These are healthcare plans that have a payment of a flat fee for each patient covered. Under a capitation agreement, a healthcare organisation pays a fixed amount of money for its members to the health care provider. The healthcare provider is paid a set monthly amount to see patients regardless of how many treatments or the number of times the physician or clinic sees the patient. Whether or not the patient needs services for a particular month, the provider will get paid the same fee.

Capitation agreements and maintenance and repair contracts (not in scope of the proposed standard) were contrasted with traditional health insurance contracts and boiler breakdown insurance respectively (in scope of the proposed standard). However, the proposed standard does not provide additional guidance on how to apply the conditions for fixed-fee service contracts to address those contracts where the assessment is less clear.

Insurance contracts should be combined and accounted for as one insurance contract if the insurance contracts are entered into at, or near, the same time with the same policyholder (or related policyholders) and if one or more of the following criteria are met:

- insurance contracts are negotiated as a package with a single commercial objective;
- the amount of the consideration to be paid for one insurance contract depends on the consideration or performance of the other insurance contract(s); or
- the coverage provided by the insurance contracts to the policyholder relates to the same insurance risk.

PwC observation

The proposals for combining contracts may have an impact on fronting arrangements, where an entity enters into an insurance contract with a direct insurer who enters into a back to back reinsurance contract. If these contracts are combined they may not meet the definition of an insurance contract and result in a net presentation in the income statement.

Separating components from an insurance contract

An insurer is required to separate components from an insurance contract (previously referred to as ‘unbundling’) that would be within the scope of another standard if they were separate contracts.

Embedded derivatives have to be separated from the insurance contract if they are not closely related to the economic characteristics of the insurance contract. In that case they should be accounted for under IFRS 9, ‘Financial instruments’. Derivatives that themselves meet the definition of an insurance contract are considered to be closely related and are not separated.

Only distinct investment components have to be separated. Unless the investment component and insurance component are highly interrelated, an investment component is distinct if a contract with equivalent terms is sold, or could be sold, separately in the same market or same jurisdiction, either by entities that issue insurance contracts or by other parties. The investment and insurance component are highly interrelated if one of the following criteria is met:

- The entity is unable to measure either the insurance or the investment component without considering the other component. Hence, if the value of one component varies according to the value of the other component, an entity applies the proposed insurance contracts standard to the whole contract containing the investment component and the insurance component; or
- The policyholder is unable to benefit from one component unless the other is present (that is the lapse or maturity of one component in a contract lapses or matures the other component).

A performance obligation to provide a good or service has to be separated if it is distinct. Performance obligations can be implied by an entity's customary business practices, published policies or specific statements if those promises create a valid expectation held by the policyholder that the entity will transfer a good or service. However, tasks such as setting up a policy do not transfer a service to a policyholder and do not represent a performance obligation. A performance obligation to provide a good or service is distinct if either of the following criteria is met:

- The entity (or another entity that does or does not issue insurance contracts) regularly sells the good or service separately in the same market or same jurisdiction taking into account all information that is reasonably available in making this determination; or
- The policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the entity or by another entity that might not issue insurance contracts), or resources that the policyholder has already obtained (from the entity or from other transactions or events).

A performance obligation to provide a good or service is not distinct if the cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract, and the entity provides a significant service of integrating the good or service with the insurance components.

PwC observation

The Board has not responded to the request for optional separation of components from an insurance contract. In certain cases, determining if services, such as asset management services, should be separated will require significant judgment. If it is determined that components have to be separated, a number of practical application issues may arise, such as how to allocate acquisition costs.

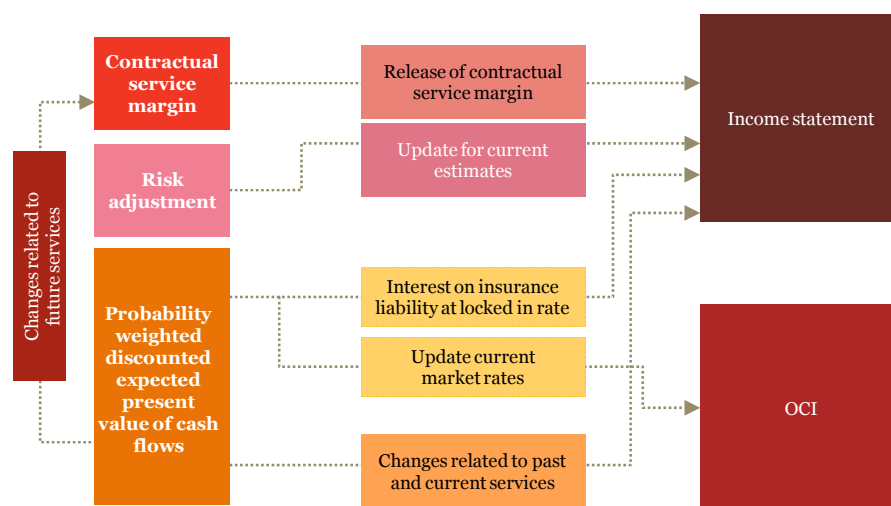
The illustrative examples 1-3 to the proposed standard are helpful in determining whether components have to be separated. We expect that separating investment components will be uncommon in many contracts as the components are highly interrelated, although these examples suggest that asset management and other services have to be separated in certain cases.

Current measurement model

The proposals require an entity to measure its insurance contracts using a current measurement model, where current estimates are re-measured each reporting period.

The measurement approach ('building block approach' or 'BBA') is based on the building blocks of a current, discounted and probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract; an explicit risk adjustment and a contractual service margin (previously called the residual margin) representing the unearned profit of the contract.

The graph¹ below shows how the changes in the building blocks flow into the income statement and into OCI in shareholder's equity on the balance sheet. The changes related to future services will be recognised against the contractual service margin as long as it has a positive balance (that is, the contract is not onerous).



The measurement model contains a liability for incurred claims and a liability for remaining coverage that have to be disclosed separately in the notes to the financial statements. A simplified approach exists for the liability for remaining coverage, which is discussed later in this practical guide.

The contractual service margin and the performance of the onerous contract test are calculated at the portfolio level, but the level of aggregation for releasing the contractual service margin and determining the risk adjustment is not prescribed.

A portfolio of insurance contracts is defined as a group of insurance contracts that:

- provide coverage for similar risks and are priced similarly relative to the risk taken on; and
- are managed together as a single pool.

In the re-deliberations, the staff provided factors to consider in determining whether contracts are subject to similar risks. These included the type of risk insured (for example, longevity, mortality, fire), the product line (for example, annuity, term insurance, motor), the type of policyholder (for example, commercial, personal, individual, group), and the geographic location. However, the proposed standard does not provide further guidance on this topic.

¹ Separate requirements apply to contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. These are discussed in a separate section in this practical guide.

PwC observation

The application of the portfolio definition is important, as it will affect the contractual service margin, day one loss recognition and the ongoing onerous contract test for contracts under the simplified approach. The Board has attempted to define a portfolio in a way that is clear enough to apply without being overly prescriptive. However, this remains a judgmental area that may have different interpretations in practice.

Cash flows

The cash flows are an explicit, unbiased and probability weighted estimate of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract. The proposed standard notes that the level of aggregation for measurement (for example portfolio or individual contracts) should not affect the expected present values of these cash flows. This expected value (or statistical mean) is determined by considering the range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for the particular outcome and the estimated probability of that outcome. The cash flows from each outcome are discounted and weighted by the probability factor to drive the expected present value. The fulfilment cash flows are not adjusted for non-performance risk.

Unlike many current accounting models that develop a single 'best estimate', all probabilities (even remote ones) are considered and weighted. However, the application guidance notes that not all cases will require the development of explicit scenarios. In cases where there are complex underlying factors that behave in a non-linear fashion, sophisticated stochastic modelling may be needed. This may, for example, happen if the cash flows reflect a series of interrelated options. The objective is to incorporate all of the relevant information and not ignore any information that is difficult to obtain.

PwC observation

Some believe that the 'actuarial central estimate' or 'best estimate' commonly used by non-life insurance actuaries in the development of estimates of unpaid losses is consistent with the approach in the proposed standard. Others believe that some components of life insurance contract estimates, such as mortality and morbidity rates, where symmetric experience is expected, also capture the concept of a mean. Whether the objective of the new measure can be achieved with existing methodologies and systems or whether major changes are required will depend on the extent to which current calculations already incorporate the concept of a mean.

Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts that they will receive. Such features include renewal options, surrender options, conversion options and options to cease paying premiums while still receiving benefits under the contracts. The measurement of an insurance contract reflects, on an expected value basis, the entity's view of how the policyholders in the portfolio that contains the contract will exercise options available to them, and the risk adjustment will reflect the entity's view of how the actual behaviour of the policyholders in the portfolio of contracts may differ from the expected behaviour. When insurance contracts contain embedded options or guarantees, it is important to consider the full range of scenarios.

The cash flows reflect the entity's perspective, but should not contradict observable market prices for market variables and incorporate all available information about amount, timing and uncertainty in an unbiased way.

PwC observation

The proposals will require stochastic modelling of options and guarantees, which may not be a common practice in certain territories. Options and guarantees can be modelled in different ways, for example by a 'market consistent approach' with reference to current market prices for variables such as equity, interest rates and real estate. Alternatively, there is the 'real world' approach, where an entity's own assumptions on relative asset performance are used. The key difference between these approaches is that in the 'real world' approach you can assume that certain asset classes will earn more in the future than other asset classes, whereas this is not appropriate in the market consistent approach. The proposals appear to suggest that a market consistent approach will be required as observable inputs have to be used when available.

For non-market variables, an entity will have to consider non-market external and internal data and give weight to the more pervasive evidence. For example, demographic characteristics for life insurers may differ from the characteristics of the national population and therefore an entity may decide to use internal data.

Entities will have to use current estimates representing the conditions at the end of the reporting period and changes therein. However, if an event that occurs after the end of the reporting period resolves a condition that existed at the reporting date, it does not provide evidence of a condition that existed at the end of the reporting period. For example, there may be a 10% probability at the end of the reporting period that a tornado will strike during the remaining six months of an insurance contract. After the end of the reporting period and before the financial statements are authorised for issue, a tornado strikes. The fulfilment cash flows under that contract should not reflect the fact that the tornado, with hindsight, is known to have occurred.

Directly attributable acquisition costs are included in the expected cash flows if they can be allocated to a portfolio on a rational and consistent basis. Acquisition costs are the costs of selling, underwriting and initiating an insurance contract and also include costs that cannot be attributed directly to individual insurance contracts in the portfolio.

Fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent and maintenance and utilities) that are directly attributable to fulfilling the portfolio that contains the insurance contract are also included in the cash flows. These are allocated to each portfolio of insurance contracts using methods that:

- are systematic and rational, and are consistently applied to all costs that have similar characteristics; and
- ensure that the costs included in the cash flows that are used to measure insurance contracts do not exceed the costs incurred.

Cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as product development and training costs are not included in the expected cash flows, but recognised in profit or loss when incurred. This also applies to cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract.

PwC observation

Entities can allocate their acquisition costs at the portfolio level, which will reduce any day one losses that entities were expecting from the previous ED.

PwC observation (continued)

Life insurers that issue both insurance and investment contracts will have to treat acquisition costs differently for these two types of contracts. Currently commissions on selling investment contracts are often deferred under IAS 18, 'Revenue' as separate assets and will continue to be deferred under the new revenue recognition proposals. However, acquisition costs on investment contracts have to be incremental at the contract level, which is different than for insurance contracts, where acquisition costs are allocated at the portfolio level. For example, , under the proposed insurance contracts standard, the costs of an internal sales department may be included in the expected cash flows if they can be allocated on a rational and consistent basis to a portfolio of insurance contracts.

Income tax payments and receipts that an entity does not pay or receive in a fiduciary capacity are recognised and measured under IAS 12, 'Income taxes' and not included in the expected cash flows. In some territories policyholder benefits are dependent on future net of tax investment returns. The proposals may not allow these future tax flows to be reflected in the measurement of the liability.

Replicating portfolio

An entity may use a replicating asset or a replicating portfolio of assets whose cash flows exactly match the contractual cash flows in amount, timing and uncertainty. In some cases, a replicating asset or portfolio may exist for some of the cash flows that arise from an insurance contract. The fair value of that asset both reflects the expected present value of the cash flows from the asset and the risk associated with those cash flows. If a replicating portfolio of assets exists for some or all of the cash flows that arise from an insurance contract, the entity can, for those contractual cash flows, use the fair value of those assets for the relevant fulfilment cash flows (that is, the expected present value of cash flows including the risk adjustment), instead of explicitly estimating the expected present value of those particular cash flows and the associated risk adjustment.

For example, an insurance contract may contain a feature that generates cash flows that are equal to the cash flows from a put option on a basket of traded assets. The replicating portfolio for those cash flows would be a put option on the same terms on that basket of traded assets. The entity would observe or estimate the fair value of that option and include that amount in the measurement of the insurance contract. However, other techniques may be more robust or easier to implement if there are significant interdependencies between the embedded option and other features of the contract. Judgement is required to determine the approach that best meets the objective in particular circumstances.

The use of a replicating portfolio technique is not required. However, if a replicating asset or portfolio does exist and an entity chooses to use a different technique, the entity has to satisfy itself that a replicating portfolio technique would be unlikely to lead to a materially different answer.

PwC observation

In many cases, entities may find it difficult to find a replicating portfolio whose cash flows exactly match the contractual cash flows of an insurance contract, due to specific risks that are included in the insurance contract. Therefore, we expect that the replicating portfolio technique will not be used often.

Mutual insurers and surplus participating funds

In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual entity has accepted the risk that is the essence of insurance contracts. The proposed standard does not contain specific requirements for mutual insurers.

The proposed standard requires that, for contracts that require the entity to hold underlying items and where cash flows vary with the returns on those underlying items, the fulfilment cash flows will include cash flows from existing contracts that provide policyholders with a share in the returns on underlying items, regardless of whether those payments are made to current or future policyholders.

PwC observation

It may be unclear whether surplus funds associated with participating contracts that have built up over time (often known as orphan estates) are expected to be paid to future policyholders and so how these should be included in the projected cash flows. For a mutual insurer, if policyholders receive the whole of any surplus, there would be no equity in the entity's financial statements.

Contract boundary

Cash flows are within the boundary of an insurance contract when the entity can compel the policyholder to pay the premiums or has a substantive obligation to provide the policyholder with coverage or other services. A substantive obligation to provide coverage under an insurance contract ends when the entity has the right or practical ability to reassess the risk of a particular policyholder and as a result can re-price or set a level of benefits that fully reflects that risk.

In addition, the substantive obligation ends if both of the following are satisfied:

- The entity has the right or practical ability to reassess the risk of a portfolio of insurance contracts and as a result can re-price or set a level of benefits that fully reflects that risk.
- The pricing of premiums up to the reassessment of risks does not take into account risks that relate to future periods.

An entity has that right or practical ability when there are no constraints to prevent it from setting the same price as it would for a new contract that is issued on that date, or if it can amend the benefits to be consistent with those that it would provide for the price that it will charge. Similarly, an entity has that right or practical ability when it can re-price an existing contract so that the price reflects overall changes in the risks in the portfolio, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the right or practical ability to set a price that fully reflects the risks in the contract or portfolio, it should consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage.

The boundary of an insurance contract is determined by considering all of the substantive rights that are held by the policyholder, whether they arise from a contract, law or regulation.

PwC observation

The requirements for the contract boundary have been clarified from the previous ED by means of an additional criterion relating to reassessing the risk for a class of policyholders. This criterion has been included to address certain health insurance and other contracts that include regulatory restrictions on re-pricing individual policies.

PwC observation (continued)

While certain individual long term disability contracts may also be priced at a ‘class’ level, the premiums are typically set considering the risk relating to future periods (for example, a straight-line premium may be due each period even though the risks are lower in earlier years). As a result, the length of such contracts under the proposed standard may be more than one year.

Time value of money and the use of OCI for changes in discount rates

The expected cash flows are discounted to reflect the time value of money of the insurance contract liability. The discount rate reflects the characteristics of the cash flows for the insurance contract liability, which means that the discount rate is consistent with the cash flows (such as currency and liquidity) and excludes effects that are not present in the cash flows. The discounting is term dependent, which will require the use of interest rate curves instead of single rates, which is common in many current accounting practices. In the simplified approach, discounting is not required for insurance contracts with cash flows that are expected to be paid within a year.

PwC observation

Complexities will arise in the use of interest rate curves rather than a single discount rate. In some situations multiple curves may be required for contracts with different benefits, some of which are based on expected investment returns and others that are not.

In some territories non-life insurers may currently not be required to discount liabilities whilst some life insurers may use locked-in discount rates under current GAAP and so the proposed standard will impose a significant change for these entities.

In determining the discount rate, an entity can use a bottom-up approach or a top-down approach, which is depicted in the following example:

Top down	
Actual or expected reference portfolio rate	7.0%
Duration mismatches	0.3%
Market risk premium for expected credit losses	-1.0%
Market risk premium for unexpected credit losses	-0.6%
Insurance contract discount rate	5.7%
<i>Difference between the two methods not required to be reconciled</i>	
Bottom up	
Insurance contract discount rate	5.5%
Liquidity premium	1.5%
Risk free rate of return	4.0%

In the bottom up approach, differences in liquidity characteristics arise when insurance liabilities do not have the same liquidity characteristics as assets that are traded in financial markets. For example, some government bonds are traded in deep and liquid markets and the holder can typically sell them readily at any time without incurring significant costs. In contrast, insurance contract liabilities cannot generally be traded, and there may be no ability under the terms of the contract for cancellation before it matures. An adjustment to the risk free rate is made to reflect the illiquid nature of the insurance contract.

In the top down approach an entity can identify a discount rate on a replicating portfolio and deduct the elements not included in the liability, such as credit risk. The proposals do not specify restrictions to the actual portfolio of assets that the entity

holds or the reference portfolio of assets used to determine the discount rate if a top down approach is adopted. Fewer adjustments would be required when the reference portfolio of assets has similar characteristics to those of the insurance contract liabilities. For example:

- For debt instruments, the objective is to eliminate from the total bond yield the factors that are not relevant for the insurance contract. Those factors include the effects of expected credit losses and the market risk premium for credit.
- For equity investments, more significant adjustments are required to eliminate the factors that are not relevant to the insurance contract. This is because there are greater differences between the cash flow characteristics of equity investments and the cash flow characteristics of insurance contracts. In particular, the objective is to eliminate from the portfolio rate the part of the expected return for bearing investment risk. Those investment risks include the market risk and any other variability in the amount and timing of the cash flows from the assets.

PwC observation

The Board's acceptance of a top down approach to set discount rates is likely to be viewed as a welcome revision by many constituents. It may result in a rate closer to that used in pricing due to inclusion of some components of the asset rate.

The basis for the assumptions used in a top-down or bottom-up approach may have a significant impact on the measurement of certain insurance contracts. Theoretically both approaches should lead to the same outcome, but this appears unlikely in practice due to the existence of components in asset yields other than credit and illiquidity (for example, as a result of market inefficiency). As observed in Solvency II in Europe and more widely in current embedded value reporting, the approach to setting the discount rate will be fundamental to the measurement of many insurance contracts.

If the extent, timing or uncertainty of cash flows from an insurance contract depends wholly or partially on the returns from the underlying items then the discount rate reflects that dependence. This is further discussed in the section on contracts with cash flows that depend on the returns of underlying items.

In response to the concerns raised with regards to volatility in the income statement, the difference between the liability discounted at the current discount rate and the rate at initial recognition will be recognised in OCI, rather than in profit or loss. The interest expense recognised in profit or loss will be based on the discount rate at initial recognition. An entity is effectively required to measure the insurance contract on a current basis in the statement of financial position and on an amortised cost basis for presentation in profit or loss. This will require an entity to apply different discount rates to different contracts according to their date of initial recognition, rather than applying only the current discount rate to all cash flows.

PwC observation

Some insurers asked for the use of OCI for changes in discount rates to eliminate or reduce some of the mismatches between assets and liabilities as when assets are held to maturity the changes in discount rate reverse over time. Therefore these insurers think these changes should not affect profit or loss. Many insurers claim that management of assets and liabilities is an inherent part of the business of insurers and the accounting should reflect that.

PwC observation (continued)

The proposed changes to IFRS 9 for certain debt instruments to be carried at fair value fair value through OCI ('FVOCI') together with the mandatory use of OCI for changes in discount rate on insurance contracts will reduce some of the concerns around volatility in the income statement. However, accounting mismatches will still remain where insurance contracts are backed by equities, derivatives, investment properties or debt instruments that do not meet the requirements for measurement at FVOCI.

Even where insurance contracts are backed by debt instruments that are measured at FVOCI, accounting mismatches may still occur if the debt instruments are sold prior to maturity as the realised gains or losses on the assets will be recycled to the income statement. Accounting mismatches will also arise where insurance contracts have periodic premiums, rather than a single upfront premium, as new premiums will be invested at current interest rates instead of the rates at inception.

Recognising the changes in discount rate in OCI will require tracking of discount rates at inception as two sets of calculations will be needed. This will add complexity especially for long-tail non-life and life insurance contracts.

Risk adjustment

The risk adjustment measures the compensation that an entity requires for bearing the uncertainty about the amount and timing of cash flows that arise as the entity fulfils the insurance contract. The risk adjustment measures the compensation to make an entity indifferent between:

- fulfilling an insurance contract that has a range of possible outcomes; and
- fulfilling an insurance contract with fixed cash flows with the same expected present value.

The risk adjustment is explicit and separate from the cash flows and discount rate. This does not preclude an entity from using a replicating portfolio technique as discussed earlier in this practical guide. However, an entity should take care not to double count risks that are already captured in the fair value of the replicating portfolio.

PwC observation

Incorporating an explicit risk adjustment into the measurement model is consistent with the pricing of insurance contracts, financial instruments and written options. It also reduces the amount of what otherwise would be a larger contractual service margin. The significance of the challenge for entities to reliably and consistently measure the risk adjustment will vary by territory depending on the experience in that territory and whether risk adjustment techniques are used for capital management or solvency requirements.

The time value of money is independent from the estimate of future cash flows; hence the risk of changes in interest rates is not part of the risk adjustment. For example reinvestment rates for long term bonds to determine an appropriate discount rate for liabilities will not affect the amount of the risk adjustment.

The risk adjustment reflects the degree of diversification benefit that the entity considers and the degree of risk aversion. The unit of account for the risk adjustment is not specified under the proposed standard, which may lead to different interpretations of diversification benefits in practice.

PwC observation

The previous ED proposed that the risk adjustment reflects the effects of diversification that arise within a portfolio but not the effects of diversification between portfolios. The proposed standard allows the risk adjustment to reflect any diversification benefit that the entity would consider when determining the compensation it would require for bearing the uncertainty. This is likely to be a welcome change for insurers who manage risk across portfolios.

The technique for determining the risk adjustment is not specified. However some characteristics have been included to meet the objective of the risk adjustment.

PwC observation

The pattern of emergence of profit will differ depending on the risk adjustment technique used, as well as the drivers influencing the risk adjustment. For example the price of capital will affect the risk adjustment if a cost of capital technique is used.

Even though the Board has not specified the technique for measuring the risk adjustment, an entity will be required to disclose the confidence level to which the risk adjustment corresponds. Whilst some believe confidence interval disclosures could be misleading for skewed distributions, the Board views the confidence level technique as relatively easy to communicate to users of financial statements and relatively easy to understand.

The risk adjustment is recognised in profit or loss as it is released from risk in both the coverage and settlement periods. This is different from the release of the contractual service margin which is discussed below.

Contractual service margin

The contractual service margin represents the unearned profit in an insurance contract and is amortised over the coverage period in a systematic way that best reflects the remaining services provided under the contract. The Board proposes that when an entity recognises the contractual service margin, they should use a level of aggregation that ensures that the contractual service margin is recognised in line with the pattern of services provided under the contracts to which they relate. This would mean that when the coverage period of each contract has ended, the contractual service margin relating to that contract should be fully recognised in profit or loss. Interest on the contractual service margin is accreted at the rate at inception. The contractual service margin cannot be negative.

PwC observation

It appears that the Board intends that a contractual service margin can be reinstated if a contract becomes profitable again after being onerous. As a consequence, the tracking of the negative contractual service margin will be required, which will lead to further complexity.

The contractual service margin is measured at the level of the portfolio (as defined earlier in this practical guide). However, the level for amortisation of the contractual service margin is not specified and has to be released according to the services provided under the contract, which is discussed further below.

PwC observation

Although the contractual service margin is calculated at the portfolio level, the requirement to accrue interest at the interest rate at inception in practice may result in entities using a smaller unit of account than the portfolio.

The contractual service margin is adjusted for changes in cash flows related to future services, but not for current and past coverage.

PwC observation

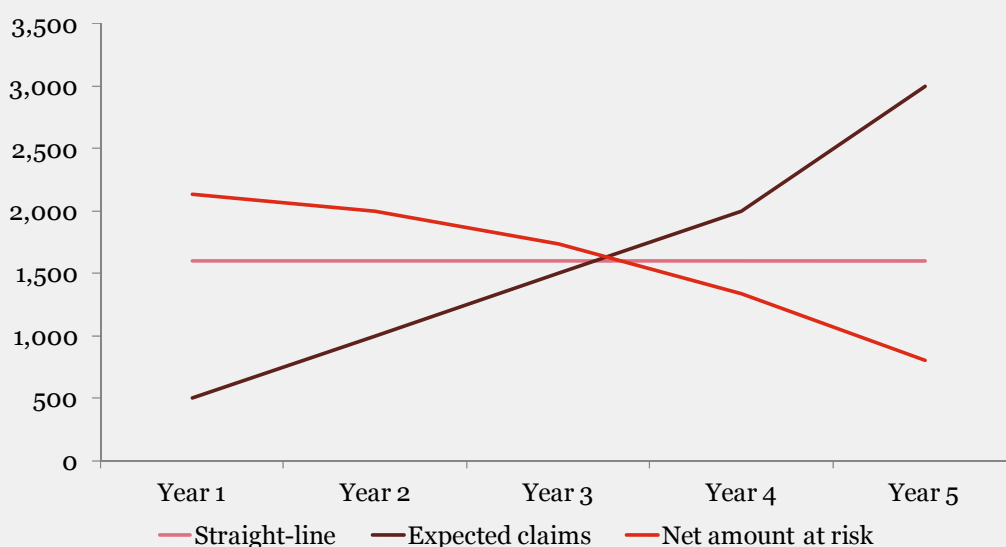
The unlocking (adjusting) of the contractual service margin to reflect changes in estimates of future cash flows may be the conceptually right answer given that a day one gain will not be recognised. However, such adjustments bring additional complexity into the proposed standard, including re-estimating the current contractual service on a current basis and calculating it, even when the current value is negative.

As opposed to changes in the cash flows, changes in the risk adjustment are not recognised against the contractual service margin. The Board proposes that all changes in the risk adjustment should be recognised immediately in profit or loss. In the Board's view the changes in the risk adjustment mainly relate to the expiry of risk, rather than future services or incurred claims, which should be recognised in profit or loss. Additionally, it would be complex for entities to separately identify those changes in the risk adjustment that relate to future services.

As mentioned before, the contractual service margin has to be amortised over the coverage period in a systematic way that will best reflect the remaining transfer of services that are provided under the contract. Hence, the pattern of services is an important element in the recognition of profit resulting from insurance contracts.

PwC observation

It is not clear for certain contracts, such as contracts with non-distinct investment components, what 'services' are. The services may be insurance coverage, expected claims, asset management and the net amount at risk or another measure. The graph below shows an example of how the impact on profit or loss can be very different if an entity uses a straight-line method, expected claims or the net amount at risk as the pattern of services under the contract to amortise the contractual service margin. The selection of the amortisation pattern is likely to be a key driver of future profits for certain contracts.

**Simplified measurement for liability for remaining coverage**

The proposed standard provides an optional simplified approach for the liability for remaining coverage for certain contracts (the 'premium allocation approach' or 'PAA'). Under the PAA, the liability for incurred claims is recognised according to the BBA, however it does not have to be discounted if the cash flows are expected to occur within a year after the claim incurred. The PAA is allowed to be used if the measurement of

the liability for remaining coverage is a reasonable approximation of the BBA or if the coverage period is one year or less.

The measurement of the liability for remaining coverage would not be a reasonable approximation if, at inception, the entity expects significant variability in the fulfilment cash flows before a claim is incurred. This will be the case if the coverage is for a long period of time or the contract includes embedded options or other derivatives.

PwC observation

The PAA is likely to apply to non-life insurers with short-duration contracts. However, many life insurers will also be able to apply the PAA to certain contracts such as employer provided group business and affinity type insurance.

The PAA is permitted, rather than required, which provides composite insurers who write both life and non-life insurance with the ability to apply one model for all insurance contracts. For those entities that do want to apply the PAA, it may be unclear in practice how an entity would go about proving that the PAA is a reasonable approximation to the BBA.

The inclusion of the time value of money for contracts where the period between the incurrence of a claim and payment is more than one year will affect the assessment of whether the PAA gives a measurement that approximates the BBA.

Some in the non-life industry have expressed concern that the requirement in the PAA to use a locked-in interest rate at the time of inception of the policy, rather than at claim inception, may require segmenting claims data based on contract inception cohort (in addition to the more widely kept loss or accident date from which claims liabilities are usually calculated).

If the criteria for the PAA are met, the liability for remaining coverage is initially measured as the premium, if any, received at initial recognition less acquisition costs plus any pre-coverage cash flows and an onerous contract liability, if applicable.

The subsequent measurement of the liability for remaining coverage includes the accretion of interest at the interest rate at initial recognition, the premiums received and the changes from any onerous liability. The liability for remaining coverage is reduced with the corresponding amount recognised as insurance contracts revenue (that is, the amount of premiums allocated in the period in a systematic way that best reflects transfer of services provided under contract). The onerous contracts liability for a portfolio of insurance contracts is recognised as the difference between the carrying value of the liability for remaining coverage and the fulfilment cash flows. If the cash flows are not discounted, the onerous contracts liability is calculated excluding the time value of money.

PwC observation

The level at which a portfolio is established could impact the likelihood of a day one loss or subsequent onerous contract determination. Some insurers currently use a higher grouping level for the current premium deficiency test than would be permitted under the onerous contracts test in the proposed standard. For example, some non-life insurers might consider their grouping for premium deficiency purposes to be commercial versus personal lines contracts, but this grouping would need to be broken down into products with different risks and pricing under these proposals.

If an insurance contract has a significant financing component, the entity adjusts the liability for the remaining coverage to reflect the time value of money as determined at initial recognition. However, the liability for the remaining coverage does not have to reflect the time value of money if the entity expects, at contract inception, that the time between the entity providing each part of the coverage and the due date for the premium that relates to that part of the coverage is one year or less.

If the PAA is used, an entity may elect to recognise as an expense the directly attributable costs if the coverage period is one year or less.

Presentation

Presentation in statement of comprehensive income for BBA

Under the proposed standard, insurance contract revenue is the transfer of promised services arising from the insurance contract at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Consequently, the change in the liability for the remaining coverage during the reporting period represents the coverage or other services that the entity provided in that period, assuming no other changes occur. The total insurance contract revenue presented over the duration of the contract is the same as the premiums received for services (excluding non-distinct investment components), adjusted for the time value of money. Insurance contract revenue can be expressed as the sum of:

- The latest estimates of the expected claims and expenses relating to coverage for the current period (excluding those recognised immediately in profit or loss).
- The change in the risk adjustment.
- The amount of the contractual service margin recognised in profit or loss in the period.
- An allocation of the portion of the premium that relates to recovering directly attributable acquisition costs. The entity allocates the part of the premium relating to the recovery of those costs to each accounting period in a systematic way that reflects the transfer of services provided under that contract.

An entity will present claims and other expenses relating to an insurance contract when incurred.

The proposed standard does not contain a prescribed income statement format and the IAS 1, 'Presentation of Financial Statements' requirements apply as for any other entity.

PwC observation

The presentation of insurance contracts revenue and expenses is one of the most controversial topics in the proposed standard. The current proposal is different from the summarised margin approach in the previous ED in response to the request for volume information and it is trying to produce a more consistent approach with general revenue recognition and the PAA. Many insurers suggest that this new approach is too complex and burdensome to produce and is not a measure they would currently use. However, one of the questions to assess is how complex the application of the insurance contracts revenue approach would be in practice in the context of the BBA model.

For many life insurers, the proposed statement of comprehensive income will represent a significant change from the way insurers present their results and key performance indicators ('KPIs') today. Management, analysts and investors will need to be educated on the new presentation format.

Investment (deposit) components

The proposed standard requires that any non-distinct investment components that are not separated from the insurance contract (hereafter referred to as the 'deposit component') are excluded from revenue and claims in the statement of comprehensive income.

The deposit component represents the cash flows that the insurer estimates it will be obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs. It is measured under the insurance model and presented along with the

remainder of the insurance contract liability or asset, but excluded from revenue and claims presented in the income statement.

Deposit components in insurance or reinsurance contracts could include explicit account balances, cash surrender values, period certain annuity payments, experience accounts and no claims bonuses. Such deposit components could exist in life, annuity, and property/casualty or non-life contracts.

At each reporting date these deposit components would be re-estimated based on current assumptions utilised in the measurement of the insurance contract, with any effect on insurance contract revenue allocated prospectively to periods in proportion to the value of coverage (and any other services) that the insurer estimates will be provided in those periods.

PwC observation

Some insurers have expressed concerns about the data and model complexity of disaggregating investment components as systems may not currently capture this information. Some insurers are concerned that it would be too complex to separate interrelated cash flows and exclude some of them from insurance contract revenue and incurred expenses.

Presentation in statement of comprehensive income under PAA

When an entity applies the PAA, insurance contract revenue for the period is determined as the amount of the expected premium receipts allocated in the period. The entity allocates the expected premium receipts as insurance contract revenue to each accounting period in the systematic way that best reflects the transfer of services that are provided under the contract.

The presentation under the PAA is therefore largely in line with the presentation in the insurance contracts revenue approach, except that entities are allowed to expense acquisition costs if the coverage period is one year or less.

Insurance contracts revenue and incurred claims are presented excluding any deposit components that have not been separated according to the requirements discussed earlier in this practical guide.

PwC observation

The new revenue approach does have the advantage of producing a single revenue measure for insurers who write contracts that are accounted for under the BBA measurement approach as well as under the PAA.

The exclusion of the deposit component from revenue is likely to affect reinsurance contracts that will often be recognised under the PAA. Reinsurance contracts often return premium to a cedant entity as a profit commission or it is paid out as a claim and these amounts would be excluded from revenue under the proposed standard.

Non-life insurers use a number of KPIs, such as gross and net written premiums, claims, expense and combined ratios. The proposed presentation would continue to enable these performance indicators to be calculated, although they may be different from the current approach due to the exclusion of deposit components and the discounting of incurred claims.

Presentation in statement of financial position

Portfolios of insurance contracts have to be presented on a net basis as insurance contract liabilities or assets. Portfolios in an asset position cannot be netted with portfolios in a liability position. Liabilities and assets under the BBA and the PAA are presented together in one line item. Ceded reinsurance contracts are presented separately from insurance contracts.

Under the PAA the right to contractual premiums will be included as part of the insurance contract net carrying amount, rather than as a gross receivable.

PwC observation

The BBA requires measuring the cash inflows and outflows including a risk adjustment. The contractual service margin eliminates a day one gain, which will lead to most portfolios of insurance contracts having a zero value at initial recognition, which may be significantly different from current practice. Additionally, the subsequent measurement of portfolios may switch from asset to liability, because of the composition of the building blocks in the BBA.

Some insurers net their portfolios of insurance contracts and present them as one single line item as an asset or liability. The proposed standard does not allow portfolios in an asset position to be netted off with those in a liability position, which may lead to a gross up of the statement of financial position for these entities.

Contracts with cash flows that vary with returns on underlying items

Certain contracts, often referred to as participating contracts, have cash flows that vary with the returns on underlying items. The Board has introduced a specific approach ('mirroring') for contracts that meet specified criteria. However, this section also explains the approach for contracts that do not meet these criteria, but where the cash flows vary with the returns on underlying items.

The 'mirroring approach' is introduced for variable cash flows that depend on the development of underlying items in contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. This linkage is determined by considering all of the substantive terms of the contract, whether they arise from a contract, the law or regulation. The mirroring only applies to those cash flows where the entity does not bear the risk of the return on underlying items. Examples are expected to include unit-linked contracts and some insurance contracts with discretionary participation features. In this approach the measurement and presentation of part of the insurance contract is consistent with the underlying items.

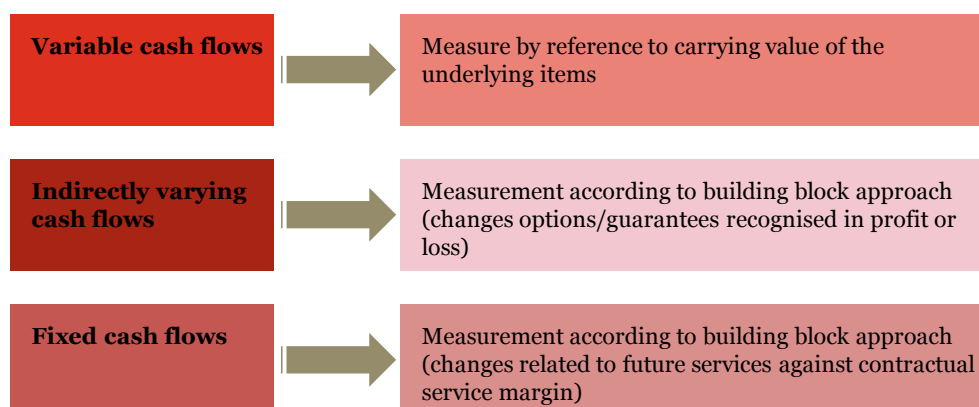
PwC observation

This aspect of the proposed standard appears to be attracting a lot of attention as entities try to understand the proposals which are very different from current accounting and the previous ED.

In the IASB's view, the criteria for adjusting the measurement basis for contracts that require the entity to hold underlying items and specify a link to returns on these items applies when there are no economic mismatches between the liabilities and the assets. The criteria will not apply when the entity is not required to hold the underlying items. Although the entity could choose to reduce economic mismatches by holding the underlying items, the possibility of economic mismatches could arise if it does not hold the items. In addition, the contract does not specify a link to the underlying items, the entity may choose to set the cash flows from the contract in a way that reflects the returns on underlying items, but the possibility of economic mismatches could arise if it does not.

The terms of participating contracts vary by territory and entities will need to assess whether their contracts qualify for the mirroring approach.

To apply the mirroring approach, an entity has to decompose the fulfilment cash flows into three different components as depicted below:



PwC observation

Although the underlying concept of mirroring where the entity does not bear the risk of the return on underlying items seems theoretically correct, the requirement to decompose the cash flows may be complex.

It is unclear from the proposed standard how the mirroring approach should be applied for participation other than investment returns (such as mortality or expenses) and how interrelated components are mirrored.

For indirectly varying cash flows (such as options and guarantees) the proposed standard requires that the changes in expected value of cash flows are recognised in profit or loss. For contracts where the entity is not required to hold the underlying assets and/or where the cash flows do not vary with underlying items, the accounting for changes in options and guarantees follow the BBA, which seems to imply the use of OCI for changes in discount rates and the unlocking of the contractual service margin. Some are questioning why changes in options and guarantees are treated differently between contracts that are eligible for the mirroring approach and those that are accounted for using the BBA.

The contractual service margin for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items is determined considering all the cash flows together. Therefore the contractual service margin will represent the expected present value of the cash inflows less the cash outflows, which will include the mirrored cash flows, options and guarantees and fixed cash flows.

Some in the industry have proposed the concept of a floating residual margin for participating contracts. This concept views the contractual service margin as the unearned profit that includes the insurer's share of future cash flows. The floating residual margin concept proposes unlocking the margin for all gains and losses arising from the underlying items. During the re-deliberations, the Board considered this proposal, but rejected it in a close vote.

The decomposing of cash flows in an insurance contract can be done in several different ways. For contracts that require the entity to hold underlying items and specify a link to returns on those underlying items, those different decompositions could result in different measurement of the insurance contract as a whole and in different amounts being recognised in profit or loss. As a result, the proposed standard specifies the approach to decomposing cash flows that should be used.

The proposed standard provides the following example for participating contracts in the application guidance; a contract promises to pay a policyholder a minimum of CU² 1,000 plus 90% of the increase in fair value of underlying assets above an initial fair value of CU 1,000.

The cash flows could be decomposed in the following ways:

1. as a fixed amount of CU 1,000 plus a written call option; or
2. as 100% of the assets plus the value of the guarantee (a written put option) less the value of the entity's 10% participation in the upside (a call option held); or
3. as 90% of the assets plus a fixed payment of CU100 plus the value of the guarantee (a written put option)³.

The proposed standard requires entities to apply the third approach in the above example, because it expresses the cash flows in a way that illustrates the extent to which the cash flows vary directly in all scenarios with the returns on underlying items and it identifies the minimum fixed payment the policyholder will receive.

PwC observation

This example is simplified and it is unclear how the decomposing of cash flows would be performed in more complex situations with multiple options and guarantees.

Unit-linked insurance contracts

Many unit-linked insurance contracts are expected to meet the criteria to follow the mirroring approach outlined above. For many contracts, the investment component of unit-linked insurance contracts would not meet the requirements for separation from the insurance contract given the interrelation of the different components. However, as discussed in the section on 'separating components from an insurance contract', certain asset management services may have to be separated. In addition, in the mirroring approach the cash flows may have to be decomposed into the components as shown above.

PwC observation

The proposed standard does not require separate presentation of pools of assets and the portion of liabilities related to unit-linked insurance contracts as proposed in the previous ED. In the Board's view, unit-linked contracts should not be treated differently from other participating contracts. Entities will continue to apply the IAS 1 requirements, which may prevent them from using the one line approach for unit-linked contracts when multiple asset classes are involved.

In proposed amendments to IFRS 9, IAS 32 and IAS 16, the board will allow entities with unit-linked contracts to recognise treasury shares and owner occupied property at fair value through profit or loss. Entities may elect to recognise these instruments at FVPL, to the extent those fair value changes relate to the interest of unit-linked contract holders in investment funds. In addition own financial liabilities, such as issued corporate bonds do not have to be derecognised and a corresponding financial asset may be recognised at FVPL.

PwC observation

It is unclear whether the amendments to IFRS 9, IAS 32 and IAS 16 apply to unit-linked investment contracts as well as unit-linked insurance contracts.

² Currency amounts are denominated in 'currency units' (CU).

³ The IASB issued an error note on 23 July 2013 to change the description of the third approach. Previously paragraph B86(c) of the revised ED stated: 'as 90 per cent of the assets plus a fixed payment of CU100 plus 90 per cent of the increase in the assets above CU1,000'.

Presentation of contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

The insurance liabilities in the statement of financial position will reflect the contractual link with the returns on underlying items.

An entity presents the decomposed cash flows in the following manner:

- Changes in the fulfilment cash flows that result from the mirroring approach are recognised in profit or loss or OCI consistently with the presentation of changes in the value of the underlying items.
- Changes in the fulfilment cash flows that vary indirectly with the returns of underlying items are recognised in profit or loss.
- Changes in the fulfilment cash flows that do not vary with the returns of underlying items, including those that vary with factors other than the underlying items and those that are fixed, are recognised against the contractual service margin, in profit or loss or in OCI in accordance with any other cash flows in the BBA.

Approach for contracts that do not meet the mirroring requirements, but where the cash flows vary with returns on underlying items

The cash flows of the insurance contract may still be dependent on underlying items in situations where a contractual link does not exist (for example universal life contracts) or where the entity is not required to hold the underlying items. For the cash flows on these contracts, the discount rate reflects the dependence on the returns on the underlying items. The discount rate is updated when an entity expects any changes in those returns to affect the amount of those cash flows, which will impact the interest expense recognised in profit or loss.

PwC observation

Universal life and similar contracts with discretionary crediting rates normally do not specify a contractual link to underlying items and therefore will not be in scope of the mirroring proposals.

Certain contracts allow, but do not require, the entity to hold underlying items or contain clauses that allow mimicking an index. Entities can choose to minimise the economic mismatches, but they are not required to do so and therefore these contracts would not qualify for the mirroring approach. Entities will apply the BBA model for these contracts and where the expected cash flows are dependent on investment returns, the discount rate shall reflect that dependence. This approach is similar to the treatment of a variable rate financial instrument measured at amortised cost.

Entities will need to assess whether the terms of their participating contracts require them to use the mirroring approach or alternatively whether they will be within these requirements where the effect of the discount rate recognised in the income statement will be updated.

Investment contracts with discretionary participating features

Investment contracts with discretionary participating features ('DPF') provide the contractual right to receive a amounts, as a supplement to an amount that is not subject to the discretion of the issuer, that are likely to be a significant portion of the total contractual benefits, whose amount or timing is contractually at the discretion of the issuer and that are contractually based on:

- the returns from a specified pool of insurance contracts or a specified type of insurance contract;
- realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
- the profit or loss of the entity, fund or other entity that issues the contract.

Those contracts are within the scope of the proposed standard, but some of the general requirements for insurance contracts are modified for these types of contracts as set out below.

The beginning of coverage period is the time when the entity becomes party to the contract (that is, when it has a contractual obligation to deliver cash at a present or future date).

The cash flows fall inside the contract boundary when the entity has the substantive obligation to deliver cash at a present or future date. The contract boundary ends when the entity has the right or practical ability to set a price that fully reflects the benefits provided.

The coverage period is the period over which the entity is required to provide the asset management or other services under the contract.

The entity shall recognise the contractual service margin over the life of the contract in a systematic way that will best reflect the transfer of the asset management services.

PwC observation

The current requirements for measurement of financial instruments do not provide sufficient detail on how to account for investment contracts with DPF and therefore as an interim measure, accounting for them as insurance contracts seems the most appropriate alternative. Investment contracts with DPF are already in scope of current IFRS 4, but because of the lack of measurement guidance, the application of the new proposals may be a significant change for some insurers.

The contract boundary for investment contracts with DPF ends when the entity has the right or practical ability to set a price that fully reflects the benefits provided. If future premiums paid into an existing investment contract with DPF attract the same benefits as premiums under a new investment contract, then these premiums will be outside the boundary of the existing contract, which may be a significant change from current practice.

Reinsurance

Reinsurance contracts held (cedant entity accounting)

For reinsurance contracts held, the usual criteria for risk transfer have to be applied as discussed earlier in this practical guide. Insurance risk is significant if an insured event could cause a reinsurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance. There must be at least one scenario with commercial substance in which the reinsurer can suffer a loss. However, if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts (also referred to as the ‘stepping in the shoes exception’).

PwC observation

The proposed standard provides a stepping in the shoes exception as stated above. If the contract meets the requirements for the exception, the cedant will account for it as a reinsurance contract, rather than as a financial instrument.

For proportional ceded reinsurance, the reinsurance contract would be recorded by the cedant at the same time that the covered direct contracts are recognised. Ceded reinsurance contracts are recognised at the start of the reinsurance coverage period when the coverage is based on aggregate losses of a portfolio of underlying reinsured contracts. For example, an excess of loss reinsurance contract effective on 1 January covering specified direct insurance contracts written for an entire calendar year (that is a ‘risks attaching’ contract) would be required to be recognised on 1 January. If this were a contract accounted for using the BBA, all expected cash flows under the

reinsurance contract would need to be estimated at 1 January and the risk adjustment and contractual service margin calculated at that date by the cedant.

PwC observation

For proportional reinsurance written on a risk attaching basis, the cedant would need to estimate a separate risk adjustment and contractual service margin under the BBA as new policies attach to the reinsurance contract. For non-proportional reinsurance covering aggregate losses, the cedant will be required to record the reinsurance contract on the day the reinsurance coverage begins. This will require projecting the expected volume of underlying business (including contracts not yet written) in order to calculate the ceded contractual service margin under the BBA. The requirements for the PAA are not modified for reinsurance contracts held.

For reinsurance contracts held, interest income is determined using the discount rates at initial recognition. The difference between the carrying amount of the reinsurance contract measured using the interest rates at initial recognition and the carrying amount of the reinsurance contract measured using current discount rates is recognised in OCI.

For the measurement of the reinsurance contract, an entity uses assumptions consistent with those used for the corresponding part of the fulfilment cash flows of the underlying direct insurance contracts. In addition, the non-performance risk of the reinsurer is included in expected cash flows, rather than applying the general impairment requirements from the financial instruments standard. Changes in the expected credit losses of the reinsurer do not relate to future services and are recognised immediately in profit or loss. The risk adjustment for a reinsurance contract held represents the direct contract risk being transferred to the issuer of the reinsurance contract and will therefore be a debit regardless of whether the reinsurance contract will be in an asset or liability position.

In the BBA, the requirements relating to the initial recognition of the contractual service margin are modified for the reinsurance contracts held as follows:

- If the expected cash outflows are less than the expected cash inflows the gain is recognised as a contractual service margin and amortised over the coverage period (or settlement period if it relates to past events).
- If the expected cash outflows are more than the expected cash inflows, the loss is recognised as a contractual service margin, unless it relates to events before the purchase of the reinsurance contract in which case it is immediately recognised as an expense in profit or loss.

PwC observation

The model to be applied for the reinsurance contract held may be different from the model for the direct insurance contract. For example in risks attaching reinsurance where risks are assumed for contracts written in the next year. The reinsurance contract may not be eligible for the PAA, whereas each of the direct insurance contracts being reinsured might be eligible for the PAA.

If the contractual service margin is calculated as being negative for a contract that reinsures past events (adverse development cover), the cedant would immediately recognise this amount as an expense in profit or loss. Some believe it would be more appropriate to treat all contracts in the same manner, whether they are covering a transfer of risk relating to past or future events.

Reinsurance contracts issued (assuming entity accounting)

The reinsurer should evaluate whether to account for a reinsurance contract under the BBA or premium allocation approach in the same manner in which an insurer would evaluate a direct insurance contract. This would be independent of, and perhaps

different from, the model the cedant would be using for the underlying direct insurance contract.

As discussed in the section above, a ‘stepping in the shoes’ exception is provided, which allows reinsurance contracts written to be accounted for as insurance contracts even when they do not expose the reinsurer to the possibility of a significant loss provided substantially all the insurance risk on the reinsured portion of the underlying direct contracts that is being transferred. Financial reinsurance contracts, where no insurance risk is being transferred will continue to be accounted for under the financial instruments standard.

PwC observation

The application of the ‘coverage period’ for reinsurance contracts may give rise to some questions related to the application of the PAA. For example, risks attaching reinsurance contracts may need special attention in evaluating whether they are eligible for the PAA.

For certain reinsurance contracts, such as aggregate coverages and risks attaching contracts, the reinsurer might have to estimate the cash flows for contracts that have not yet been written by the direct insurer.

Recognition, modification and derecognition

Recognition

An entity recognises an insurance contract that it issues from the earliest of the following:

- the beginning of the coverage period;
- the date on which the first payment from policyholder becomes due; or
- the date on which the portfolio to which the contract will belong is onerous.

An entity recognises any cash flows paid or received before the insurance contract is recognised that directly relate to the acquisition or fulfilment of the portfolio of insurance contracts that will contain the insurance contract (the pre-coverage cash flows).

PwC observation

The previous ED required recognition from the moment an entity became party to an insurance contract, which would not necessarily have to be the same as the insurance coverage period. This is likely to be a welcome change for insurers as it is likely to be more consistent with the current recognition. However, for European entities, differences may exist between this recognition point and Solvency II, which requires recognition when the entity becomes party to the contract. The level of difference will depend on the onerous contract test in IFRS.

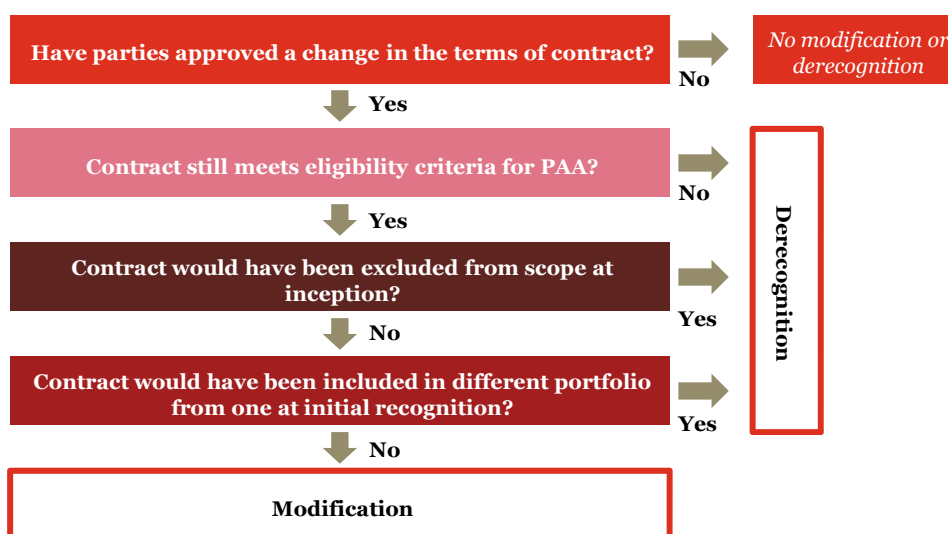
Onerous contracts

A portfolio of insurance contracts is onerous if the fulfilment cash flows at initial recognition plus any pre-coverage cash flows result in a negative contractual service margin. As a negative contractual service margin is not allowed, this amount is immediately recognised in profit or loss.

Modification and derecognition

If the parties to the insurance contract agree to a change in the terms of the contract, an entity has to assess whether the change qualifies as a modification or derecognition.

The following flowchart provides guidance on which changes to the terms of the contract result in a modification of the contract and which ones result in derecognition of the contract:



For modifications an obligation is recognised for additional benefits resulting from the modification as a new contract. The contractual service margin is determined by reference to the additional premiums received.

An entity accounts for the reduction in benefits by derecognising part of the contract that is related to the reduction in benefits. Any changes in the cash flows that are not accompanied by a change in the level of benefits are recognised as changes in estimates of the fulfilment cash flows. Any gains or losses on the modification of an insurance contract are recognised as an adjustment to the cash flows from the contract.

An entity derecognises an insurance contract when it is extinguished or when it has met the requirements in the flowchart above. If a change in the terms of the contract results in derecognition, an entity derecognises the extinguished part of the insurance contract and recognises a new contract according to the proposed standard. The entity recognises a gain or loss in profit or loss measured as the difference between:

- the deemed consideration for the new contract, which is the premium that the entity would have charged the policyholder if it had entered into a contract with equivalent terms at the date of the contract modification; and
- the carrying amount of the derecognised contract.

When an entity derecognises insurance contracts, it should reclassify to profit or loss as a reclassification adjustment (according to IAS 1) any remaining amounts that relate to those contracts that were previously recognised in OCI.

Business combinations and portfolio transfers

For insurance and reinsurance contracts acquired in a business combination or a portfolio transfer, the date of recognition is deemed to be date of the portfolio transfer or business combination. The consideration received or paid for a contract in a business combination or portfolio transfer is treated as a pre-coverage cash flow and excludes any consideration for other assets and liabilities acquired in the same transaction.

In a business combination, the consideration received or paid is the fair value of the contracts acquired at that date. That fair value reflects the portion of the total consideration for the business combination relating to the liabilities assumed.

The initial measurement of contracts acquired in a business combination is used when determining any goodwill or gain from a bargain purchase in accordance with IFRS 3, 'Business combinations'.

PwC observation

The current practice of recognising a separate asset for the value of business acquired in a business combination will be eliminated.

If a business combination has occurred before transition, any transition adjustments relating to the business combination should be taken against retained earnings and not against goodwill.

Foreign exchange

The proposed standard requires that an insurer treats the insurance transactions executed in a foreign currency as monetary items when applying the foreign currency guidance. This requirement applies to all components of the insurance including the contractual service margin.

PwC observation

Insurers currently treat unearned premiums and deferred acquisition costs as non-monetary items. Classification of the insurance contract as a monetary item will eliminate today's accounting mismatches that arise when these items are supported by financial assets that are classified as monetary items.

Disclosures

The disclosures required are to enable users to understand the nature, amount, timing and uncertainty of cash flows from insurance contracts. The disclosure requirements focus on three areas, being the disclosures around the amounts recognised in the financial statements, significant judgements and the nature and extent of risks. The key disclosure requirements in the proposed standard are included in Appendix 3.

An entity has to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity has to aggregate or disaggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics. Examples of disaggregation bases that might be appropriate are:

- type of contract (for example major product lines);
- geography (for example country or region); or
- reportable segment, as defined in IFRS 8, 'Operating segments'.

PwC observation

The disclosure requirements are more detailed than currently required under IFRS 4 and may result in additional system and data requirements. For example, systems will have to be able to capture and produce information to present the reconciliation of movements in insurance and reinsurance balances and their components.

This is one of the first EDs where the impact of the Board's disclosure project is seen. The proposed standard emphasises that if any of the disclosures are not considered relevant in meeting the disclosure objective as discussed above, they may be omitted from the financial statements. However, if the disclosures provided are insufficient to meet the objective, entities will have to disclose additional information that is necessary to meet those requirements.

PwC observation (continued)

The previous ED required entities to provide disclosures at a level lower than the segment level according to IFRS 8. The new proposals allow the segment level to be used as an aggregation levels. The level of disaggregation required to satisfy the disclosure objective will be a matter of judgment. Preparers will need to find a proper balance to avoid providing too much information, or aggregating items with different characteristics.

Transition

Each portfolio is measured at transition using the BBA including a contractual service margin. The difference between the amount calculated from applying the BBA and the existing net insurance contract balance is reflected in opening retained earnings and if applicable, OCI. Any balances for deferred acquisition costs and intangible assets related to insurance contracts that do not meet the intangible asset definition are derecognised upon transition.

Retrospective application is required unless this is impracticable according to IAS 8. If this is the case, the following simplifications are required for the building blocks:

- Assume all changes in estimates of cash flows between the date of initial recognition and the beginning of earliest period presented were already known at the date of initial recognition, which allows the use of hindsight.
- Use the observable yield curve that approximates the yield curve for at least three years before the transition date. If this is not available, an entity applies a spread (averaged over at least three years if possible) to the observable yield curve that approximates the yield curve.
- The risk adjustment at initial recognition is deemed to be the same amount as at transition.

PwC observation

The extent of the opening retained earnings adjustment on the initial application of the standard will be influenced by many factors including the expected profitability of the business written as well as the previous accounting policies applied.

In the IASB's view, measuring the building blocks would often be subject to bias through the use of hindsight and retrospective application would often be impracticable. The simplifications provided for estimating the cash flows, discount rate and the risk adjustment seem pragmatic and beneficial to entities as it will be difficult in practice not to use hindsight, especially for contracts initiated many years ago.

In the transition simplifications, at the date of initial recognition the risk adjustment is assumed to be the same as the risk adjustment at the date of the earliest period presented. This simplification would most likely understate the risk adjustment at the date of initial recognition, but the IASB has been unable to identify an approach that is more objective.

Not all disclosures as required by IAS 8 have to be included upon transition. An entity does not have to disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it first applies the proposed standard.

Also, an entity does not have to disclose, for the current and each prior period presented, the amount of the adjustment for each line item that is affected as this would require an entity to run parallel systems for a certain period of time.

IFRS 9 reclassifications

An entity will follow the reclassification requirements within IFRS 9 (that is reclassifications are only permitted in case of a change in the business model). However, on adoption of the insurance contracts standard, an entity is:

- Permitted to designate eligible financial assets under the fair value option ('FVO') where new accounting mismatches are created.
- Required to revoke previous designations under the FVO where an accounting mismatch no longer exists.
- Permitted to newly elect to use OCI for presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke previous elections.

PwC observation

For insurers, the timing of the implementation of the proposed insurance contracts standard and IFRS 9 is critical. Insurers ideally would like to adopt both new standards at the same time. If this is not the case, insurers will only be able to reassess their business model under IFRS 9 if the business model has changed and not because of the adoption of the proposed insurance contracts standard. This may lead to accounting mismatches if the insurance standard moves in a different direction than expected when IFRS 9 is implemented.

Next steps

The proposed standard will significantly affect all entities that issue insurance contracts. The new proposals add significant complexity and create extra demands on resources, data and modelling systems, and stakeholders need to understand the changes. The impact of the proposals will vary from one territory to another, depending on current accounting and regulatory requirements.

Given the likely significant impact of the standard, management should assess the implications of the new proposals on their existing contracts and current business practices. Management should also consider commenting on the proposed standard to ensure its views are taken into account. The comment period ends on 25 October 2013, and the effective date will be approximately three years from the date of publication of the final standard.

PwC observation

The re-deliberations on the ED will not start before the end of 2013 and will run into 2014. Depending on the feedback that will be received on the proposed standard, producing a final standard in 2014 may prove to be a challenge for the Board. Given the approximately three years of preparation that will be given to entities, the effective date will likely not be before 1 January 2018.

If you have questions about the proposals in the ED or require further information, visit inform.pwc.com or speak to your regular PwC contact.

Appendix 1 – Comparison between revised ED for insurance contracts and 2010 exposure draft

Description	What has changed?
Definition and scope	<ul style="list-style-type: none"> Revised scope includes investment contracts with a discretionary participation feature but only if they are issued by an entity that also issues insurance contracts. Clarified scope exceptions by including more guidance about which fixed-fee services contracts are within the scope of the proposed standard. Carried forward the current requirements of IFRS 4 and IFRS 9 for financial guarantee contracts. The entity can elect to apply the proposed standard to financial guarantees that it issues if it previously treated those contracts as insurance contracts. The entity applies IFRS 9 if the entity has previously accounted for those contracts as financial instruments.
Separating components from insurance contracts	<ul style="list-style-type: none"> Clarified the principles for separating components from the insurance contract. Added guidance on the allocation of the cash inflows and cash outflows between the insurance and non-insurance components.
Recognition	<ul style="list-style-type: none"> Changed the recognition point to the point at which the coverage period begins (or when the payment from the policyholder is due, if earlier). Requires an entity to recognise the contract before the start of the coverage period when the insurance contract is onerous.
Acquisition costs included in estimates of cash flows	<ul style="list-style-type: none"> Revised requirement so that all directly attributable costs that arise when originating the portfolio of insurance contracts are included in estimates of cash flows. Requires insurance contract revenue related to the recovery of those costs to be reported as the entity satisfies its contractual obligations by providing services.
Contract boundary	<ul style="list-style-type: none"> Amended the contract boundary so that cash flows are outside the boundaries of the existing contract if an entity is able to re-price the portfolio that includes the contract, so that the price charged for the portfolio as a whole fully reflects the risk of the portfolio.
Time value of money	<ul style="list-style-type: none"> Clarified guidance to indicate that both ‘top-down’ and ‘bottom-up’ approaches are acceptable for developing a discount rate that is consistent with the characteristics of the liability. Included more application guidance on calculating the ‘top-down’ rate.
Risk adjustment	<ul style="list-style-type: none"> Revised the objective to reflect the compensation that the entity requires for bearing the risk of uncertainty that is inherent in the cash flows that arise as the entity fulfils the portfolio of insurance contracts. Eliminated the restriction of techniques to determine the risk adjustment. Revised the approach to diversification benefits so that, when determining the risk adjustment, the entity considers the effects of diversification benefits considered in the compensation required for bearing the uncertainty.
Contractual service margin	<ul style="list-style-type: none"> Introduced a requirement that an entity must adjust the contractual service margin for changes in estimates of cash flows related to future coverage or future services. The contractual service margin cannot be negative. Revised the pattern for recognising the contractual service margin over the coverage period to be on a systematic basis that reflects the remaining transfer of services that are provided under the contract.

Description	What has changed?
Modifications to insurance contract	<ul style="list-style-type: none"> Introduced requirements for the accounting of modifications to an insurance contract.
Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items	<ul style="list-style-type: none"> Introduced requirements for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. For such contracts, an entity is required to measure and present fulfilment cash flows that are expected to vary directly with returns on underlying items on the same basis as the underlying items.
PAA - Eligibility	<ul style="list-style-type: none"> Revised to permit entities to apply the PAA if: <ul style="list-style-type: none"> Doing so would produce a reasonable approximation to the BBA; or The coverage period is within one year or less.
PAA - Measurement	<ul style="list-style-type: none"> Introduced additional simplifications, including an exception from discounting both the liability for the remaining coverage and the liability for incurred claims if the entity meets the criteria. Revised the requirement to assess whether a contract is onerous only when facts and circumstances indicate that the portfolio may be onerous.
Reinsurance contracts held - Recognition point	<ul style="list-style-type: none"> Revised the recognition point to the beginning of the coverage period if the reinsurance coverage is based on aggregate losses of underlying direct insurance contracts; otherwise, when the underlying direct insurance contracts are recognised.
Reinsurance contracts held - Contractual service margin	<ul style="list-style-type: none"> Revised to require that an entity must recognise a contractual service margin (being expected net profit or net cost) over the coverage period. Revised to require that the entity must recognise immediately in profit or loss the net cost related to past events. Introduced a requirement that an entity should adjust the contractual service margin for changes in estimates of cash flows related to future coverage or future services. Changes in expected credit losses are recognised in profit or loss because they do not relate to future services.
Reinsurance contracts held - Premium-allocation approach	<ul style="list-style-type: none"> Clarified that the policyholder of a reinsurance contract could apply the premium-allocation approach provided it meets the eligibility criteria.
Interest expense in profit or loss and other comprehensive income	<ul style="list-style-type: none"> For contracts that require the entity to hold underlying items and specify a link to returns on those underlying items, the entity will: <ul style="list-style-type: none"> recognise and present changes in estimates of those fulfilment cash flows that are expected to vary directly with returns on underlying items consistently with changes in estimates of the underlying items; recognise changes in fulfilment cash flows that are expected to vary indirectly with returns on underlying items in profit or loss; and recognise and present changes in other fulfilment cash flows as it does for other contracts. For other contracts, the entity recognises in profit or loss interest expense on the insurance contract liability using the discount rates that were applied when the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity updates the discount rates when it expects any changes in those returns to affect the amount of those cash flows. An entity recognises in OCI, the income and expense that arise from changes in the insurance contract liability other than the amounts recognised in profit or loss.

Description	What has changed?
Presentation of insurance contract revenue and expenses	<ul style="list-style-type: none"> Added requirements for the entity to present insurance contract revenue in the statement of profit or loss and OCI over the coverage period, and claims and expenses when incurred. The amount of revenue and claims recognised excludes investment components.
Disclosures	<ul style="list-style-type: none"> Revised some disclosures in response to feedback received on the 2010 Exposure Draft and on the changes in presentation of insurance contracts: <ul style="list-style-type: none"> added disclosure for new contracts written in the period; added a reconciliation between premiums received and amount of insurance contract revenue presented; added disclosure requirements for the insurance contracts and reinsurance contracts to reconcile the difference between the expected cash flows, risk adjustment and contractual service margin included in the opening and closing balance; added disclosure requirements for reconciling the insurance contracts and reinsurance contracts; eliminated the required disclosures for measurement uncertainty analysis; and eliminated the prohibition against aggregating information about different reportable segments required by IFRS 8.
Transition	<ul style="list-style-type: none"> Introduced requirements to apply the proposals retrospectively in accordance with IAS 8 when practicable. Provided simplifications if retrospective application is impracticable.
Designation of financial instruments using IFRS 9	<ul style="list-style-type: none"> Revised to permit an entity, when first applying the proposals, to re-designate some financial assets provided specified criteria are met.

Appendix 2 – Comparison between revised ED for insurance contracts and the FASB ED

Description	FASB ED	Revised IASB ED
Scope	<p>Participating investment contracts accounted for as financial instruments.</p> <p>Financial guarantee contracts that meet the definition of insurance are in the scope of the proposed update.</p>	<p>Participating investment contracts issued by entities that also issue insurance contracts are in scope of the proposed insurance contract standard.</p> <p>Financial guarantee contracts are excluded from the scope unless the issuer has previously asserted explicitly that it regards those contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply IFRS 7 and IFRS 9 or the proposed insurance contracts standard.</p>
Fulfilment cash flows	Cash outflows do not include other expenses unrelated to or only indirectly related to satisfying specific obligations, such as commissions, transaction-based taxes or levies.	Cash outflows include commissions, transaction-based taxes and levies that arise directly from existing insurance contracts or can be attributed to them on a reasonable and consistent basis.
Acquisition costs	Cash outflows exclude the portion of acquisition costs that are deemed not to result in the issue of contracts.	Cash outflows include all directly attributable costs of acquiring the portfolio of insurance contracts.
Risk adjustment and margin	Margin represents the expected unearned profit for the portfolio of insurance contracts, without identifying an explicit risk adjustment.	The measurement of the insurance contract includes an explicit risk adjustment.
Contracts that require an entity to hold underlying items and specify a link to returns on items	<p>Mirroring approach not applicable where the contractual obligation to the policyholder is directly linked to the fair value of the underlying investments. The contract is instead measured at the fair value of the underlying investments, with changes in those obligations presented in profit or loss.</p> <p>The FASB's approach would apply only to the level of returns contractually linked, and not to any additional discretionary amount of returns that the entity expects to pass to policyholders. For example, if a contract specifies that at least 80% of returns must be passed to policyholders and the entity expects to pass to the policyholder 90% of the returns. Under the FASB's approach, 80% of the returns would be measured on that basis.</p>	<p>Mirroring approach applies to policyholders' participation where expected cash flows vary directly with underlying items and where entity is required to hold the underlying items.</p> <p>The IASB would mirror the expected level of returns. In the example, the IASB would measure the cash flows relating to 90% of the returns on the same basis as the underlying items.</p>
Changes in estimates of fulfilment cash flows	All changes in estimates should be recognised immediately in net income.	Unless the contract is onerous, all changes in estimates relating to future coverage or future services should be offset against the contractual service margin except for contracts with discretionary participation features.

Description	FASB ED	Revised IASB ED
Margin (risk adjustment and contractual service margin) release patterns	<p>The margin should be recognised in net income over the coverage and settlement periods as the entity is released from risk as evidenced by a reduction in the variability of cash outflows.</p> <p>The implicit margin in the liability for remaining coverage for contracts measured using the premium allocation approach is allocated over the coverage period.</p>	<p>The risk adjustment should be re-measured each reporting period with changes recognised immediately in net income.</p> <p>The contractual service margin should be recognised in net income over the coverage period in a systematic basis that is consistent with the pattern of transfer of services that are provided under the contract.</p>
Use of the premium allocation approach	<p>The premium allocation approach is a required separate model and should be applied for all contracts meeting specified criteria.</p>	<p>The premium allocation approach is a simplification and may be applied for any contracts when it would produce similar measurements to the BBA or where the coverage period is one year or less.</p>
Reinsurance	<p>Reinsurance contracts held should be accounted for using the same approach used to account for the underlying insurance contracts issued.</p>	<p>Reinsurance contracts held may be accounted for using a different approach than the approach applied to the underlying contracts.</p>
Transition	<p>When determining the margin, an entity may elect to measure the insurance contract liability and the margin using its determination of the portfolio immediately before transition.</p> <p>If impracticable to apply the standard retrospectively as no objective information is available, the margin is zero.</p>	<p>When determining the margin at transition, an entity should determine the portfolio in accordance with the proposed definition.</p> <p>If it is impracticable to apply the proposed standard retrospectively, an entity should estimate the contractual service margin, taking into account all objective information that is reasonably available and apply specified simplified requirements.</p>

Appendix 3 – Summary of disclosure requirements in the revised ED for insurance contracts

Amounts recognised in the financial statements

Detailed roll forward schedules and reconciliations for insurance and reinsurance contracts, separately reconciling the liabilities for remaining coverage, the onerous contracts liabilities and the liabilities for incurred claims.

Separate reconciliation of opening to closing balances of the expected future cash flows, the risk adjustment and the contractual service margin for insurance contracts under the BBA.

Reconciliation from premiums received to revenue recognised.

Relationship between the effects of interest on insurance liabilities and the investment return on related assets.

If the mirroring approach has been used, entities disclose the amounts arising from cash flows where mirroring has been applied as well as any difference between the fair value of the underlying items and the carrying value and which part will be passed on to the policyholder.

Cash outflows, acquisition costs, change in risk adjustment and contractual service margin recognised in the period in determining the insurance contract revenue under the BBA.

For contracts initially measured in the period and measured using the BBA, the expected future cash flows, risk adjustment and contractual service margin.

Significant judgements in applying the standard and changes therein

Methods used to measure insurance contracts and the processes for estimating the inputs to those methods (where practicable quantitative).

Methods and inputs to estimate building blocks and pattern of recognition of the contractual service margin and not separated investment components and effect of changes in methods and inputs.

Confidence level corresponding to the risk adjustment if this technique is not used.

Yield curve (or range of yield curves) used to discount the cash flows that do not depend on the returns from underlying items. When an entity provides disclosures in total for a grouping of portfolios, it should provide such disclosures in the form of weighted averages or relatively narrow ranges.

Nature and extent of risks arising from insurance contracts

Nature and extent of risks arising from insurance contracts and objectives, policies and processes for managing risks and methods used to manage those risks.

Insurance risk on gross/net basis (before and after risk mitigation, such as reinsurance), including sensitivity and concentrations of insurance risk.

Quantitative disclosures about non-insurance risks (credit, liquidity and market risk) based on information provided internally to key management personnel including concentration risk.

Quantitative disclosures about the maximum exposure to credit risk and information about credit quality of reinsurance assets.

Quantitative disclosures about how liquidity risk resulting from insurance contract liabilities is managed, the amounts payable on demand and a maturity analysis of the insurance contract liabilities for each of the first five years and in aggregate beyond the first five years.

Quantitative disclosures about market risk from not separated embedded derivatives including a sensitivity analysis and the (changes in) methods and inputs for the sensitivity analysis.

Effect of regulatory frameworks, such as minimum capital requirements or required minimum interest rate guarantees.

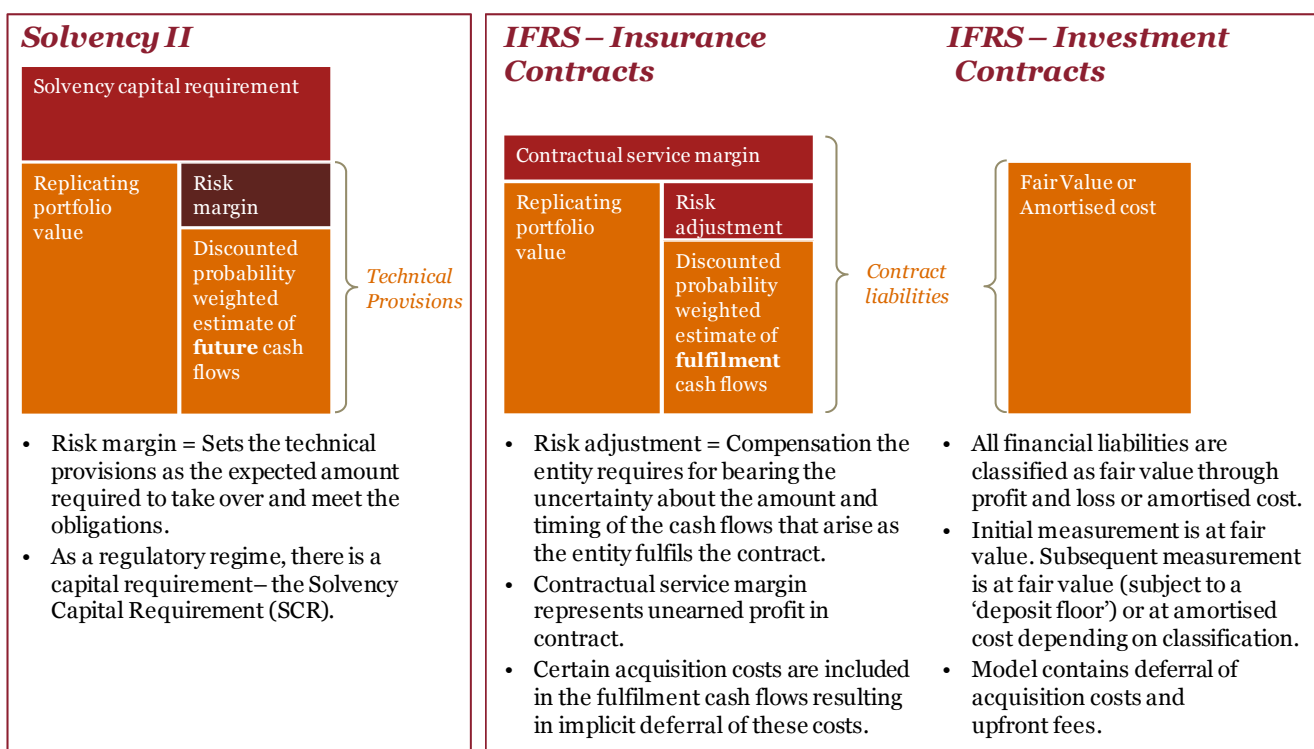
Claims development for not more than ten years reconciled to the carrying amounts of the liability and asset position. An entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it first applies the proposed standard.

Appendix 4 – Comparison between Solvency II and the revised ED for insurance contracts

Solvency II looks virtually certain to be delayed from the planned January 2014 launch date with January 2016 a more likely date. Following the completion of EIOPA’s Long Term Guarantee Impact Assessment, the negotiations between the European Parliament, the European Commission and the Council of Europe (member states) to finalise Solvency II have now reconvened (10 June was first Trilogue) and all parties appear to want to finalise Omnibus II by the year end 2013.

With the potential for early adoption of the new IFRS standard and the likely delay to Solvency II, the opportunity for reporting projects to, once again, be considered together re-emerges. It will start to become clearer over the next year whether a real option exists to early adopt the new IFRS standard when Solvency II is launched, providing an opportunity to develop a single communication strategy and to clear out legacy issues in one go.

The figures below show the high-level differences between the Solvency II model and the Insurance contracts ED. For more information please refer to our publication: ‘Laying the foundations for the future of insurance reporting’ and the webcast on www.pwc.com: Insurance regulation goes beyond Solvency II.



On the next page we have summarised our high level observations of the differences between the proposed standard for insurance contracts and Solvency II. The significance is shown as High (H), Medium (M) and Low (L).

Topic	IFRS - Insurance Contracts	Solvency II	Significance	Observations
Definition and scope	Insurance and participating investment.	All contracts.	M	The measurement of investment contracts in IFRS may be significantly different to Solvency II.
Recognition	Date coverage begins (plus onerous contract test for period before coverage begins).	Date party to contract.	L	The level of difference will depend on the onerous contract test in IFRS. For many contracts the recognition will be the same.
Separating components	Distinct investment components, embedded derivatives and certain goods and services.	No.	M	It is expected that the scope of separating components from an insurance contract is relatively limited so this difference may not be significant.
Contract boundary	No longer required to provide coverage or contract does not confer any substantive rights to policyholder.	Amend terms to 'fully reflect risk'. No projection of premiums for savings contracts.	M	The contract boundary definition could be different between Solvency II and IFRS. In Solvency II (unlike IFRS), there is a requirement to separate contracts into components, where the contract boundary differs between components.
Cash flows (excluding acquisition)	Incurred directly to fulfil portfolio of contracts.	Prescribed.	M	There is a risk of differences in the cash flows included in the two frameworks. For example, the treatment of certain overhead expenses.
Acquisition costs	Directly attributable at portfolio level.	Expensed as incurred.	H	In IFRS, there is 'implicit' deferral of acquisition expenses. There is no equivalent concept in Solvency II.
Discount rate	Top down or bottom up (current and locked-in for OCI purposes).	Prescribed based on swaps + (Matching adjustment or counter-cyclical premium - TBC ⁴) (current rates only).	H	The discount rate is the most significant area of uncertainty in Solvency II. It is unclear how the Solvency II discount rate will compare to the principle based approach in IFRS. Two sets of discount rates (current and at inception) are required for IFRS income statement presentation.
Risk adjustment / margin	No prescribed method.	Prescribed 6% cost of capital.	M	The Solvency II risk margin is prescribed, while the IFRS risk adjustment is principle-based. It is likely that there will be differences in the two approaches.
Contractual service margin	Eliminate day-one gain (update for certain subsequent changes).	No.	H	There is no concept of deferring day one profit in Solvency II.

⁴ Long Term Guarantees Assessment report by the European insurance regulatory (EIOPA) in June 2013 proposed replacing the counter-cyclical premium with a separate measure outside of the discount rate (known as the "Volatility Balancer").

Topic	IFRS - Insurance Contracts	Solvency II	Significance	Observations
Participating contracts	Cash flows from participating feature included (consistent with asset valuation and presentation).	Cash flows from participating feature included (except for 'approved surplus funds').	M	<p>The linkage of the cash flows in IFRS to the asset measurement and presentation is a significant difference to Solvency II if assets are not at fair value through profit or loss.</p> <p>The treatment of residual participating fund assets and the allocation between liability and equity will depend on the specific nature of the contracts and national law. The comparison between IFRS and Solvency II is currently unclear.</p>
Short duration contracts	Unearned premium liability while cash flow projection for claims liability.	As for other contracts.	M	In IFRS, the unearned premium model is optional. A cash flow approach can be adopted as in Solvency II.



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