July 2010

148. DSR-Sitzung am 03.09.2010

148_08d_100730_ED_insurance_BC_bereits mit Mail vom 30.07.10 versandt

Basis for Conclusions
Exposure Draft ED/2010/8

Insurance Contracts

Comments to be received by 30 November 2010

Basis for Conclusions on Exposure Draft

INSURANCE CONTRACTS

Comments to be received by 30 November 2010

ED/2010/8

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Insurance Contracts* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **30 November 2010.** Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

The IASB, the IFRS Foundation, the authors and the publishers do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

ISBN for this part: 978-1-907026-92-8
ISBN for complete publication (set of two parts): 978-1-907026-90-4

Additional copies of this publication may be obtained from:
IFRS Foundation Publications Department,
1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.
Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
Email: publications@ifrs.org Web: www.ifrs.org

CONTENTS

Basis for Conclusions on the exposure draft *Insurance Contracts*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 The International Accounting Standards Board developed the exposure draft *Insurance Contracts* after analysing responses to the proposals in its discussion paper *Preliminary Views on Insurance Contracts* (published in May 2007). The exposure draft is part of phase II of the Board's project on accounting for insurance contracts.

BC2 This Basis for Conclusions summarises the Board's considerations in reaching the conclusions in the exposure draft. Individual Board members gave greater weight to some factors than to others.

Background

The Board's project on insurance contracts

BC3 The Board's predecessor organisation, the International Accounting Standards Committee, began a project on insurance contracts in 1997. The Board was constituted in 2001 and included that project in its initial work plan. Because it was not feasible to complete the project in time for the many insurers that would adopt International Financial Reporting Standards (IFRSs) in 2005, the Board split the project into two phases.

BC4 The Board completed phase I in 2004 by issuing IFRS 4 *Insurance Contracts*, which:

(a) made limited improvements to accounting practices for insurance contracts.

(b) permitted a wide variety of accounting practices for insurance contracts to continue, thus avoiding major changes that phase II might reverse.

(c) required an insurer to disclose information about insurance contracts.

BC5 The Board aims to complete phase II of the insurance contracts project by issuing an IFRS based on the proposals in the exposure draft. The objective of phase II is to develop a high quality standard addressing the recognition, measurement, presentation and disclosure requirements for insurance contracts. The Board believes that IFRS 4 cannot remain in place indefinitely because it permits diversity in practice, including many practices that do not provide users of financial statements with information that is relevant and representationally faithful. In particular, existing practice has the following flaws:

(a) Some practices have developed in a piecemeal fashion over many years and do not provide a coherent framework for dealing with more complex contracts (such as multi-line or stop-loss contracts) or resolving emerging issues with new types of insurance contract.

(b) Accounting methods have sometimes been tailored more to meeting the needs of insurance regulators than to meeting the sometimes different needs of investors and other capital providers.

(c) Some practices used by insurers differ from those used by other entities, particularly other financial institutions, such as banks and fund managers, but there is not a sound reason for all those differences. These differences impede comparisons between insurers and other financial institutions. They can also mean that financial conglomerates produce financial statements that are internally inconsistent.

BC6 In May 2007 the Board published a discussion paper setting out its preliminary views on the main components of an accounting model for an insurer's rights and obligations (ie assets and liabilities) arising from an insurance contract. The Board received 162 comment letters in response. Most respondents said that a new IFRS for insurance contracts was needed urgently and agreed with the Board that the measurement of an insurance contract should take into account three building blocks: estimates of future cash flows, the effect of the time value of money and a risk adjustment. However, virtually all respondents had significant concerns about particular aspects of those building blocks. Feedback on the discussion paper's proposals is discussed in paragraphs BC45–BC50.

BC7 After publishing the discussion paper, the Board continued to consult the Insurance Working Group, a group of senior financial executives of insurers, analysts, actuaries, auditors and regulators that was established in 2004. In addition, in 2009 the Board conducted field tests to

understand better some aspects of the practical application of the proposed insurance model. Sixteen insurers, based in Asian, Australian, European and North American markets and with life, non-life and reinsurance businesses, participated.

FASB views on insurance contracts

BC8 In August 2007 the US Financial Accounting Standards Board (FASB) issued to its constituents an Invitation to Comment *An FASB Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*, which included the IASB discussion paper. The FASB received 44 comment letters in response. In October 2008 the FASB decided to participate in the project jointly with the IASB. However, this project is not part of the Memorandum of Understanding agreed with the FASB, which has the aim of achieving improvements in accounting standards and increasing the convergence of IFRSs and US generally accepted accounting principles (GAAP).

BC9 After the FASB joined the project, most of the Board's discussions on the insurance contracts model were held jointly with the FASB and many of the decisions on the features of the model were made jointly with the FASB. However, the Board is publishing its exposure draft on insurance contracts separately from the FASB. The FASB plans to publish a discussion paper to seek additional input from constituents. That discussion paper would present the IASB's proposals, the FASB's tentative decisions, and a comparison of each of those models with existing US generally accepted accounting principles (GAAP).

BC10 This Basis for Conclusions identifies the few areas in which the IASB and the FASB reached different views on particular aspects of the insurance accounting model. Differences between the IASB's decisions and those of the FASB are summarised in the Appendix.

The proposals in the exposure draft

BC11 The exposure draft proposes a comprehensive measurement approach for all types of insurance contracts, although a modified version of that approach would apply for some short-duration contracts. That comprehensive measurement approach:

(a) would measure an insurance contract using a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects the contract to generate as it fulfils the contract (paragraphs BC14–BC155).

(b) would provide information about the main drivers of insurance contract profitability in the current period (paragraphs BC156–BC187).

BC12 This Basis for Conclusions first discusses the Board's proposals on how an insurer measures and presents insurance contracts in its financial statements. It then discusses how those conclusions helped shape the other proposals in the exposure draft:

(a) scope (paragraphs BC189–BC225). The draft IFRS would apply to insurance contracts as defined in the draft IFRS (ie life and non-life, direct insurance and reinsurance), in both the pre-claims period (the coverage period when the insurer is standing ready to meet valid claims) and the claims handling period (when the insured events have occurred but the ultimate payment is uncertain). The draft IFRS would also apply when an issuer of a financial instrument with a discretionary participation feature accounts for such an instrument.

(b) recognition and derecognition (paragraphs BC226–BC229). The draft IFRS proposes that an insurer should recognise an insurance contract when it becomes party to the contract and derecognise it when the liability has been extinguished.

(c) reinsurance (paragraphs BC230–BC241). The draft IFRS proposes that the same model applies to reinsurance and to direct insurance.

(d) disclosures (paragraphs BC242–BC253).

(e) transition, effective date and early adoption (paragraphs BC254–BC257).

BC13 Finally, this Basis for Conclusions describes the Board's assessment of the benefits and costs of implementing the draft IFRS (paragraphs BC258–BC263).

Measurement (paragraphs 16–66)

The need to revise the measurement model

BC14 Insurance contracts create a bundle of rights and obligations that generate a package of cash inflows and cash outflows, including:

(a) premiums received from the customer.

(b) benefits paid to policyholders to satisfy valid claims.

(c) costs of investigating whether claims are valid and of settling those claims (claims handling costs).

(d) costs of servicing contracts during their life.

(e) additional payments to holders of participating insurance contracts (eg dividends and bonuses).

(f) interest credits to holders of account-driven contracts, such as the contracts known in some countries as universal life contracts.

(g) payments resulting from the options, guarantees and other derivatives embedded in many insurance contracts.

BC15 The simplest insurance contracts, for example many non-life insurance contracts, provide only insurance coverage. However, many other insurance contracts blend together several types of cash flows arising from various components that would, if issued as free-standing contracts, be subject to a variety of accounting treatments. Those components include:

(a) pure insurance, as noted above.

(b) pure deposits, for example financial instruments whereby an entity receives a fixed sum and undertakes to repay that sum with fixed interest on a fixed date.

(c) financial derivatives, for example interest rate options or options linked to an equity index.

(d) non-insurance services, such as pension administration, asset management or custody services, for example of mutual fund assets.

BC16 Examples of contracts that contain such components are:

(a) life insurance contracts with significant deposit elements.

(b) unit-linked contracts (known in some countries as variable contracts) with guarantees of minimum returns in specified circumstances, such as on death, maturity, surrender or annuitisation.

(c) participating contracts that provide insurance coverage and an investment return, supplemented by guarantees of a minimum investment return in specified circumstances.

(d) life insurance contracts with surrender options, conversion options, options to cease or suspend payment, or options to reduce or extend coverage.

BC17 The Board considered the following approaches to developing an accounting for insurance contracts:

(a) applying generally applicable IFRSs to insurance contracts (paragraphs BC18–BC35).

(b) selecting an existing model for accounting for insurance contracts, such as existing US GAAP (paragraphs BC36–BC38).

(c) developing a new accounting model appropriate to insurance contracts (paragraphs BC39–BC44).

Applying generally applicable IFRSs

BC18 Insurance contracts are excluded from the scope of many current or proposed generic standards that might otherwise apply to such contracts, including standards on:

(a) Revenue recognition (see exposure draft *Revenue from Contracts with Customers*, published in June 2010).

(b) Liabilities (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, see also the related exposure draft *Measurement of Liabilities in IAS 37*, published in January 2010).

(c) Financial instruments (see IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 9 *Financial Instruments*, IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosure*. See also the related exposure drafts proposing amendments to those IFRSs, such as the exposure draft *Fair Value Option for Financial Liabilities*, published in May 2010).

BC19 Broadly speaking, bringing insurance contracts within the scope of those standards would have the following consequences:

(a) An insurer would identify service elements and deposit elements within each premium.

(b) For the service element, the insurer would account for the premium as proposed in the exposure draft *Revenue from Contracts with Customers* (see paragraphs BC20–BC32). The insurer would account for the claims liability in accordance with IAS 37 (see paragraph BC33).

(c) The insurer would apply the financial instruments standards to the deposit element.

Revenue recognition

BC20 If an insurer applied the proposals in the exposure draft *Revenue from Contracts with Customers* ('the proposed revenue recognition model'), to the service elements of the premium, the insurer would:

(a) identify the separate performance obligations in the contract, and allocate the revenue element across those performance obligations to determine the transaction price for each performance obligation.

(b) measure those performance obligations that remain unsatisfied at the amount of transaction price that is allocated to those performance obligations.

(c) recognise an additional liability if a performance obligation is onerous.

(d) recognise revenue as the insurer satisfies a performance obligation by providing insurance coverage. Typically, revenue would be recognised continuously over the coverage period.

(e) recognise a claims liability when a claim is incurred.

BC21 It would not be difficult to apply the revenue recognition model to some types of insurance contract, eg many short-duration contracts, and that model would provide useful information for users. Indeed, the result of applying the revenue recognition model to those contracts would be largely similar to the approach proposed in the draft IFRS on insurance contracts. Paragraphs BC145–BC148 explain this in more detail.

BC22 However, for other types of insurance contract, it would be much more difficult to apply the revenue recognition model and the results would be of limited use to users. Examples of some of the problem areas are:

(a) stop-loss contracts and some contracts with significant deductibles.

(b) contracts for which the expected cost of an insured event is likely to fluctuate both up and down over time (eg for some types of guarantee).

(c) contracts that implicitly provide protection against a decline in insurability.

(d) annuities.

(e) investment management services in participating insurance contracts.

BC23 The following example illustrates the problem with applying the proposed revenue recognition model to stop-loss contracts and to contracts with deductibles. Suppose a stop-loss contract covers 90 per cent of aggregate losses during 2010 that exceed CU10 million,* up to a maximum payment of CU9 million (ie 90 per cent of aggregate losses in the layer between CU10 million and CU20 million). The premium is, say, CU1.2 million. Consider now the position at 30 June 2010. Suppose that aggregate losses for the first six months are CU5 million, and aggregate losses for the rest of the year might be less than CU5 million (probability 60 per cent), between CU5 million and CU15 million (total probability 35 per cent, with all amounts within that range equally likely) or CU15 million or more (probability 5 per cent). To apply the revenue recognition model to this contract, it would be necessary to answer the following questions:

(a) To what extent has the insurer satisfied its performance obligation at 30 June 2010? How much revenue should the insurer recognise at that date as a result?

(b) How much, if any, should the insurer recognise as a claims liability at 30 June 2010? At that date it does not yet know whether it will be required to pay any claims at all for the year, but it could have to pay as much as CU9 million for the year as a whole, and the expected value of its payments for the whole year is CU2,025,000.†

BC24 Applying the model proposed in the draft IFRS, the insurer does not need to identify an amount of revenue attributable to the coverage for the six months to 30 June 2010, or to identify an amount of 'incurred' losses at that date. It simply measures the contract as the sum of the expected present value of the remaining cash flows (the present value of CU2,025,000) plus a risk adjustment plus the remaining amount of the residual margin identified at inception.

BC25 The revenue recognition model is also not particularly well suited to contracts for which the risk is likely to fluctuate both up and down over time (eg for some types of guarantee). Suppose an equity-linked life insurance contract provides a death benefit equal to the higher of (a) the account value and (b) 100 per cent of the amount invested. Thus, the insurer bears the risk that the policyholder may die at a time when the

---

* In this Basis for Conclusions monetary amounts are denominated in 'currency units (CU)'.

† There is a 35% probability that the insurer will pay CU4,500,000 and a 5% probability that it will pay 9,000,000. Thus, the expected value of losses for the whole year = (35% × 4,500,000) + (5% × 9,000,000) = CU2,012,500.

account value is less than the amount invested. For bearing this risk, the insurer charges an explicit or implicit additional premium of CU1,000. Halfway through the life of the contract, what part of the insurer's performance obligation has it satisfied if the account value stands at (a) 130 per cent of the amount invested? (b) 100 per cent of the amount invested? (c) 70 per cent of the amount invested? What if the account value goes down to 70 per cent of the amount invested and then goes back up to 100 per cent? The revenue recognition model does not provide ready answers to these questions.

BC26 Many life insurance contracts pose another difficulty for the revenue recognition model. Consider a 20-year life insurance contract with monthly fixed level premiums, with the insurer having no ability to reprice the contract during its term. The premium paid for each month provides the policyholder with two benefits:

(a) coverage against death during that month.

(b) coverage against the possibility of a decline in insurability, or even against becoming uninsurable, in the event of bad health.

BC27 In principle, the revenue recognition model would require the insurer to estimate at inception the stand-alone selling price for each month of coverage, or find some reasonable approximation that would allocate the total premium in a reasonable way across each month of coverage. Moreover, for the coverage for, say, the 70th month of cover, the revenue recognition model would require the insurer, at least in principle, to estimate the stand-alone selling price at inception for that month's coverage. Estimating that price is likely to be difficult because insurers do not generally sell such forward coverage separately. The pricing of such forward cover would need to consider how the characteristics of a portfolio might change between inception and the 70th month for example, because of adverse selection (ie the fact that the policyholders with different characteristics are likely to exercise lapse or other options in different ways, leading to an increasing concentration of policyholders who present above-average levels of risk).

BC28 A life-contingent annuity can be viewed as a series of pure endowments. A pure endowment is a contract that pays a specified benefit if the policyholder is alive on a specified date. Each of those pure endowments obliges the insurer to stand ready to pay out the specified benefit if the policyholder survives to the specified date. Thus, for annuities, the revenue recognition model would, in principle, require the insurer to allocate the total transaction price across each pure endowment contained in the contract. Assuming the annuity requires monthly

payments, the insurer would recognise each month as revenue the portion of the transaction price allocated to the obligation maturing in that month. Furthermore, for policyholders who die during the month, the insurer no longer has any performance obligations to them and so would recognise the remaining transaction price as revenue during that month. And if the policyholders are expected to live longer than previously expected, the insurer would need to reallocate transaction price across performance obligations accordingly. The resulting model is not likely to provide useful information to users and it is likely to be complex to implement.

BC29 For some participating insurance contracts, the insurer provides investment management services and provides a guarantee of minimum investment returns, receiving in exchange a portion of the upside potential on the underlying assets. The revenue recognition model would require the insurer to identify and estimate the amount of consideration receivable from the policyholder (in the form of a portion of the upside potential) and allocate it across satisfied and unsatisfied performance obligations.

BC30 A further problem arises because the revenue recognition model applies different approaches to contract rights and unsatisfied performance obligations, by measuring:

(a) the contract rights on an expected present value basis.

(b) the unsatisfied performance obligations at the amount of consideration allocated to those obligations, supplemented by an onerous contract test based on future cash flows.

BC31 Applying different approaches to contract rights and performance obligations amounts to an implicit assumption that the contract generates two separate streams of cash flows that are independent of each other. However, that is not the case for many insurance contracts. As an example, consider a 20-year life insurance contract with monthly premiums. If the contract lapses because the policyholder does not pay the premium for month 60, the insurer will not pay death benefits if the policyholder dies in month 61 or after. Similarly, if the policyholder dies in month 35, the insurer will not receive premiums for month 36 or after. Accounting for the inflows separately from the outflows would not represent their nature faithfully because it would imply that the inflows and outflows do not affect each other. In contrast, the approach proposed in the draft IFRS treats all inflows and outflows in the same manner.

BC32 In summary, applying the revenue recognition model would be relatively easy for some insurance contracts (eg many short-duration contracts) and would provide relevant information for users, but would be complex and produce information of limited relevance for other types of insurance contracts. In contrast, the model proposed in the draft IFRS would provide useful information for all types of insurance contract.

Applying IAS 37 to the claims liability

BC33 If an insurer were to apply IAS 37 to the claims liability, it would recognise a claims liability as insured events occur, and would measure that claims liability both initially and subsequently in accordance with IAS 37. That measurement would involve current estimates of cash flows and a current market-based discount rate reflecting the risks specific to the liability. In January 2010, the exposure draft *Measurement of Liabilities in IAS 37* elaborated on those requirements by proposing that the measurement should be the amount the entity would rationally pay to be relieved of the obligation. That exposure draft also included more explicit proposals on the inclusion of a risk adjustment and on the inclusion of a margin broadly corresponding to the service margin proposed in the discussion paper on insurance contracts.

Treating deposit elements as financial liabilities

BC34 If an insurer accounted for the deposit elements of an insurance contract in the same way as other financial liabilities, the insurer would:

(a) measure the deposit elements at fair value through profit or loss or at amortised cost (as applicable).

(b) measure the deposit elements so that the fair value of the deposit element would be no less than the amount payable on demand, discounted from the first date that the payment could be required (the 'deposit floor', discussed in paragraphs BC65 and BC66).

(c) account separately for embedded options and guarantees when so required by financial instruments standards (see paragraphs BC76–BC82).

(d) recognise acquisition costs as an expense when incurred, with no corresponding gain at inception. Under IAS 39, if the deposit element is measured at amortised cost, incremental transaction costs relating to the deposit element would reduce the initial carrying amount of that liability.

BC35 Other reasons why the Board rejected the idea of simply bringing insurance contracts within the scope of generic standards are the difficulty, and possible arbitrariness, of identifying which deposits and which embedded derivatives should be accounted for separately and the complexity and lack of usefulness of applying different approaches to different components of complex contracts.

Selecting an existing model

BC36 Some respondents to the discussion paper (mainly from the US) suggested that the Board should develop an approach based on existing US GAAP for insurers. The Board rejected this approach because existing US GAAP for insurers is based on numerous standards developed at different times.

BC37 The Board also decided that it would not be appropriate to account for insurance contracts using other existing accounting models because many such models:

(a) do not use current estimates of all cash flows.

(b) do not include an explicit risk margin.

(c) fail to reflect the time value or intrinsic value of some or all embedded options and guarantees, or they determine time value or intrinsic value in a way that is inconsistent with current market prices.

(d) capture both the intrinsic value and the time value of some, but not necessarily all, embedded options or guarantees by treating them as free-standing derivatives (an approach often described as 'bifurcation' or 'unbundling'). Paragraph BC41 describes why the Board does not think that such bifurcation approaches result in a faithful representation of the rights and obligations in an insurance contract.

(e) present an insurer's financial performance, particularly for life insurance, in a manner that is difficult for users to understand.

BC38 Accordingly, the Board concluded that it should develop an accounting model specifically for insurance contracts.

A new accounting model for insurance contracts

BC39 The draft IFRS proposes a new accounting model that reflects the Board's view that insurance contracts blend financial elements with service elements in various proportions, depending on the type of contract, and

that those elements combine to generate a package of cash inflows and cash outflows. The model comprises the following elements:

(a) a direct measurement that incorporates the underlying cash flows at their expected present value and includes a risk adjustment. The draft IFRS uses the term 'present value of fulfilment cash flows' to refer to that measurement.

(b) a residual margin that reports profitability of the contract over the coverage period. The residual margin is part of the consideration received or receivable from the policyholder and is determined at inception. The accounting for the residual margin is largely consistent with the proposed treatment of customer consideration in the exposure draft *Revenue from Contracts with Customers*.

BC40 The Board rejected an approach in which the accounting for an insurance contract attempts to identify a predominant component, because this would probably create significant discontinuities between the accounting for similar contracts that lie on different sides of an arbitrary dividing line.

BC41 The Board also rejected an approach that accounts separately for each component in the contract (a bifurcation approach). In the Board's view, bifurcation approaches do not faithfully represent the package of rights and obligations in an insurance contract for the following reasons:

(a) There is inherent arbitrariness in determining when a component should be bifurcated. This may result in separation of one component but not of another component that generates similar exposures. For example, a cedant may be required to bifurcate an embedded option or guarantee from a reinsurance asset, but not the same exposure in the underlying direct insurance contracts issued by the cedant.

(b) Bifurcation ignores interdependencies between components with the result that the sum of the values of the components does not equal the value of the entire contract, even at inception. Moreover, after inception, components may be measured on different measurement bases, causing even greater divergence between the sum of the carrying amounts of the components and the value of the contract as a whole. Furthermore, applying different accounting requirements to components can be complex and may not generate relevant or understandable information for users.

(c) If significant interdependencies are present, the embedded option or guarantee is itself likely to meet the definition of an insurance contract. In that case, the embedded option or guarantee is

unlikely to be bifurcated, even if similar risks arise from other embedded derivatives that do require bifurcation.

BC42 Although the Board has rejected a bifurcation approach, the proposed accounting model would require components of an insurance contract to be separated (ie unbundled) if the cash flows attributable to the individual component can be identified separately. The draft IFRS specifies particular components of an insurance contract that should be unbundled. This is discussed in paragraphs BC210–BC219.

BC43 In the Board's view, the main benefit of proposing a single method for all types of insurance contracts, including reinsurance contracts (with some modification for some short-duration contracts, as discussed in paragraphs BC145–BC148), rather than a patchwork of different approaches for different contract types and contract features, is that this would provide users with information prepared consistently for these various types. It would also limit the need for arbitrary rules on matters such as embedded derivatives and financial reinsurance. The model also provides a coherent framework to deal with more complex contracts (such as multi-year, multi-line or stop-loss contracts and contracts that contain embedded options and guarantees). This would enable emerging issues to be resolved within that framework rather than by developing specific responses to those issues that could result in the creation of unprincipled distinctions or arbitrary new rules. It would also reduce the need for the Board to respond to developments in practice by issuing frequent amendments to the IFRS.

BC44 Furthermore, the Board believes that the particular model proposed in the draft IFRS would produce relevant information for users of an insurer's financial statements because it provides:

(a) more relevant information about the amount, timing and uncertainty of future cash flows that will arise as the insurer fulfils its existing insurance contracts.

(b) explicit and robust estimates of cash flows, using a consistent approach for all changes in estimates that is also consistent with the approach to estimating future cash flows for other financial and non-financial liabilities in IFRSs.

(c) information about risk, through the inclusion of an explicit risk adjustment. This would be relevant information for users because accepting and managing risk is the essence of insurance.

(d) consistent treatment of both the time value and intrinsic value of all options and guarantees embedded in insurance contracts.

(e) clear reporting of economic mismatches that occur when insurance liabilities and related assets respond differently to the same changes in economic conditions.

(f) a reduction in accounting mismatches that arises if changes in economic conditions affect assets and liabilities equally, but the accounting requirements do not adjust the carrying amounts of those assets and liabilities equally in response to those economic changes.

(g) consistency with observable current market prices for financial market variables, such as interest rates and equity prices, to the extent that they are available.

(h) a presentation approach that highlights the main drivers of an insurer's profitability during the period.

(i) a clear and understandable approach for acquisition costs, by treating incremental acquisition costs as cash flows arising from the related insurance contract. Non-incremental acquisition costs would be recognised as an expense when incurred. (See paragraphs BC135–BC140.)

Development of the measurement approach

BC45 The draft IFRS proposes that an insurer should measure an insurance contract in a way that portrays a current assessment of the insurance contract, based on the present value of the fulfilment cash flows and a residual margin that reports profitability of the contract over the coverage period. This measurement approach is based on the building blocks approach proposed in the discussion paper. As discussed below, the Board has modified its previous proposals in the light of responses to the discussion paper and input provided by the Insurance Working Group and others.

BC46 The discussion paper proposed that insurers should measure their insurance contracts at current exit value, representing the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The discussion paper proposed that an insurer should determine that amount using the following three building blocks:

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.

(b) current market discount rates that adjust the estimated future cash flows for the time value of money.

(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).

BC47 Respondents to the discussion paper generally agreed that the three building blocks of cash flows, time value of money and a risk margin provided a useful framework for thinking about the measurement of insurance contracts and largely supported the following features of the building block approach:

(a) using current estimates of cash flows, rather than carrying forward estimates made at contract inception (ie locked-in estimates).

(b) using interest rates and, if applicable, equity prices that are based on observable market data.

(c) using the expected value (ie probability-weighted average) of future cash flows rather than a single, most likely outcome. Some respondents expressed concerns about using expected value. Although these concerns were sometimes expressed in terms of disagreement with the principle, the root of many of the concerns seemed to be about how this principle would be applied in practice.

(d) reflecting the time value of money (although, as noted in paragraphs BC88–BC104, some disagreed with this for non-life insurance).

(e) including a risk margin, and recognising income as the insurer is released from risk (although, as noted in paragraphs BC105–BC120, some disagreed with this for non-life insurance).

(f) recognising a gain at inception to reflect the expected recovery of acquisition costs from the overall contract margins.

BC48 Because respondents generally agreed with the proposals specified in paragraph BC47, this Basis for Conclusions does not discuss them again unless otherwise noted above.

BC49 Although respondents to the discussion paper generally found the three building blocks a helpful tool for analysis, virtually all respondents had concerns about significant aspects of the particular building blocks proposed in the discussion paper and its proposed objective of a current exit value. Those concerns can be summarised as follows:

(a) *Fulfilment cash flows*: Many respondents suggested that the objective of the measurement approach should reflect the fact that insurers generally expect to fulfil their liabilities over time by paying benefits and claims to policyholders as they become due, rather than reflecting an estimate of the price for a transfer of the liabilities to a third party. They stated that a transfer objective is the wrong principle for items that will not be, and often cannot be, transferred, even if current exit value might often be very close to a fulfilment value in practice. In addition, those respondents objected to current exit value because:

(i) it requires the insurer to use estimates of the cash flows that would arise for market participants, rather than cash flows that would arise for the insurer itself. Although these two sets of cash flows would probably be similar in most respects, except possibly for servicing costs in some cases, respondents generally believed that reference to market participants would be confusing and would produce less relevant information.

(ii) it reflects the risk that the debtor (in this case, the insurer) will not fulfil its obligation to perform under the contract (non-performance risk or own credit risk). Most respondents opposed the inclusion of non-performance risk.

(iii) it could lead to gains at the inception of an insurance contract. The discussion paper expressed the Board's view that such gains would arise rarely in practice, and explained that the Board was divided on whether to calibrate current exit value at inception in such a way that no gain would be recognised at inception. Respondents were similarly divided on whether an insurer should recognise gains at inception, beyond any gains relating to recovery of acquisition costs.

Paragraphs BC51–BC87 describe the Board's discussion of fulfilment cash flows.

(b) *Policyholder behaviour and participation*: Many respondents expressed concerns about the discussion paper's approach to future premiums and other aspects of policyholder behaviour and to payments to participating policyholders. They expressed the view that measurement should focus on the contract as a whole, and should not try to assess whether each element of a contract meets the definition of an asset or a liability (paragraphs BC67–BC75).

(c) *Time value of money*: There were mixed views among respondents about how to discount the cash flows arising from insurance contracts. In particular:

(i) There were mixed views about whether discounting and risk margins are appropriate for non-life insurance contracts. Paragraphs BC89–BC94 describe the Board's reasons for requiring discounting for all insurance contracts. Similar considerations apply to risk adjustments.

(ii) Most respondents agreed with the Board that the discount rate for non-participating liabilities should reflect the characteristics of the liabilities, not those of the assets backing those liabilities. However, other respondents supported using asset-based rates, to be consistent with common pricing practice and to avoid recognising large losses at inception for contracts that, on an expected value basis, are likely to be profitable. Paragraphs BC95–BC97 discuss this issue further.

(iii) Some respondents questioned whether the discount rate used to discount cash flows arising from insurance contract should be a risk-free rate or whether there should be an adjustment for liquidity. Paragraphs BC98–BC104 discuss this issue further.

(d) *Risk margins*: Many respondents requested more information on how to estimate risk margins and were concerned about the lack of observable benchmarks for risk margins. Some advocated narrowing the range of acceptable methods for estimating risk margins, although many said that guidance on estimating risk margins should be based on principles.

(e) *Service margin*: Most respondents opposed the inclusion of a service margin.

BC50 In the light of comments made by respondents to the discussion paper and subsequent discussions, the Board amended the proposed measurement model as follows:

(a) The model focuses on the fact that insurers generally fulfil their contracts directly over time by paying benefits and claims to policyholders, rather than by transferring the contracts to a third party. In addition, the model does not reflect the risk of non-performance by the insurer, and prohibits the recognition of a gain at inception (paragraph BC51).

(b) The model treats the contract as a single liability or asset, without assessing individual components for separate recognition. This is particularly relevant when considering how to measure the effects of policyholder behaviour and future premiums and policyholder participation (paragraphs BC67–BC75).

(c) The Board proposes to narrow the range of permitted methods for determining the risk adjustment (margin) and to provide additional guidance on its determination (paragraphs BC105–BC120).

(d) The model does not include an explicit service margin. If any such margin is implicit in the pricing of contracts, it would be reflected in the residual margin.

Fulfilment cash flows (paragraph 22(a))

BC51 The draft IFRS proposes that insurers should measure insurance liabilities using cash flows that will arise through fulfilment because this reflects how the insurer expects to extinguish the liability—by fulfilling the liability through payment of benefits and claims to policyholders as they become due. The present value of the fulfilment cash flows is built up from an estimate of future cash flows (paragraphs BC53–BC87), an adjustment for the time value of money (paragraphs BC88–BC104) and an adjustment for risk (paragraphs BC105–BC120).

BC52 This section discusses:

(a) cash flows that arise from future premiums (paragraphs BC53–BC66).

(b) cash flows that arise from participating features in the contract (paragraphs BC67–BC75).

(c) cash flows that arise from embedded options and guarantees (paragraphs BC76–BC82).

(d) changes in the estimates of future cash flows (paragraphs BC83–BC87).

Cash flows that arise from future premiums (paragraphs 26–29)

BC53 To identify the future cash flows that will arise as the insurer fulfils its obligations, it is necessary to distinguish whether future premiums (and resulting benefits and claims) arise from:

(a) existing contracts (which are included in the measurement of the contract) or

(b) future contracts (which are not included in the measurement of the existing contract).

In other words, it is necessary to draw a contract boundary.

BC54 The essence of a contract is that it binds one or both of the parties. If both parties are bound equally, the boundaries of the contract are generally clear. Similarly, if neither party is bound, it is clear that no genuine contract exists. However, it may be more difficult to determine where the boundaries lie if the contract binds one party more tightly than the other party. The Board focused on common contracts that bind the insurer but not the policyholder, by requiring the insurer to continue to accept premiums but permitting the policyholder to stop paying premiums, although possibly for a penalty.

BC55 Clearly, the point at which the insurer is no longer required to provide coverage and the policyholder has no right of renewal is one point on the boundary of the existing contract. Beyond that point, neither party is bound.

BC56 Similarly, at the point at which the insurer has the right (conferred by the contract) or the practical ability (eg through access to claims information) to reassess the risk presented by a policyholder and, as a result, can set a price that fully reflects that risk, the insurer is no longer bound by the existing contract. Thus, any cash flows arising beyond that point occur beyond the boundaries of the existing contract and should be related to a future contract, not to the existing contract.

BC57 A contract may permit an insurer to reprice a contract on the basis of general market experience (eg mortality experience) but without permitting the insurer to reassess the individual policyholder's risk profile (eg the policyholder's health). In this case, the insurance contract binds the insurer by requiring it to provide the policyholder with something of value (ie continuing insurance coverage without the need to undergo re-underwriting). Therefore, the Board concluded that if the insurer can reprice an existing contract, but cannot at that time reassess the individual policyholder's risk profile, that point lies within the boundary of the existing contract. Thus, the cash flows resulting from that repricing are regarded as arising within the boundaries of the existing contract.

BC58 An insurer may have the right or the practical ability to reassess the risk presented by a policyholder, but not have the right to set a price that fully reflects that risk. In that case, the Board concluded that the contract still binds the insurer. Thus, that point would not lie on the boundary of the

existing contract, unless the restriction on the insurer's ability to reprice the contract is so loose that it is expected to have no commercial substance (ie the restriction has no discernible effect on the economics of the transaction). In the Board's view, if a restriction has no commercial substance, it does not bind the insurer.

BC59 The draft IFRS captures the above conclusions by proposing that the contract boundary is the point at which the insurer is no longer required to provide coverage, or has the right or the practical ability to reassess the risk of the particular policyholder and can set a price that fully reflects that risk. The Board expects that these two tests will often give the same result in practice, but the first test is written in a manner that may be more intuitive for single premium contracts and the second test is written in a manner that may be more intuitive for recurring premium contracts.

BC60 The approach to contract boundaries proposed in the discussion paper is substantially the same as the approach proposed in the draft IFRS, except that the draft IFRS proposes a single test for the contract boundary, whereas the discussion paper proposed two tests depending on whether a contract was onerous:

(a) an onerous test for a contract that is, or has become, onerous—under that test, the insurer would include future premiums from those contracts (and other cash flows, such as claims and policyholder benefits, arising from those premiums) that would result in an increase in the liability.

(b) a guaranteed insurability test for a contract that is not onerous—under that test, the insurer would include those premiums from those contracts (and other cash flows relating to those premiums) that permit the policyholder to continue its coverage without reconfirmation of risk and at a price that is contractually constrained.

BC61 Because of the distinction in the discussion paper between the onerous and guaranteed insurability tests, an insurer would have had to separate the contract cash flows into two buckets. Arguably, the resulting measurement is not the measurement of any real world economic phenomenon. Moreover, performing that separation would have been difficult and costly. In addition, pooling of experience between onerous contracts and non-onerous contracts is a fundamental feature of insurance, and applying different tests would be inconsistent with that fact.

BC62 The Board concluded that defining one test for the boundaries of an existing contract is preferable to an approach that requires one test for an onerous contract and a different test for a contract that is not onerous.

BC63 The discussion paper treated:

(a) all cash flows arising from onerous contracts within a portfolio as arising from the contract.

(b) the additional cash flows captured by the guaranteed insurability test for non-onerous contracts as arising from a customer relationship asset, rather than from the contract. However, rather than recognising and measuring those cash flows separately, the discussion paper proposed including them in the measurement of the insurance contract. Thus, the practical effect was the same as if those cash flows had been regarded as arising from the contract.

BC64 After reviewing the responses to the discussion paper, the Board reconsidered the approach proposed in the discussion paper for the following reasons:

(a) In practice, an insurer might be able to estimate that some contracts within a portfolio have become onerous, but would often not know which contracts are in that category. If the discussion paper's analysis were valid, an insurer could, in principle, write a contract that would transfer to another party those cash flows treated as contractual without at the same time transferring the cash flows treated as non-contractual. However, the insurer could not do that if it does not know which contracts are onerous.

(b) Taken to its logical extreme, the customer-relationship analysis would imply that whenever a liability to a policyholder contains an embedded option, the measurement of the liability should assume that (i) the customer will exercise the option in the way that is least favourable to the issuer and (ii) any offset to the amount for expected 'non-optimal' behaviour by the customer should be recognised as a customer relationship asset, and not included in the measurement of the liability. However, even proponents of the customer-relationship analysis are generally unwilling to carry that analysis through in every case.

(c) The amount that the discussion paper analysed as resulting from a customer-relationship approach does not attempt to represent all of the customer relationship asset (eg possible cross-selling opportunities), but does so only to the extent of cash flows that

arise from contracts in force. Thus, the label 'customer relationship' is not descriptive of what it purports to depict.

BC65 The issue of contract boundaries is related to another question, namely whether an insurer should apply a deposit floor in measuring insurance contracts. The deposit floor is a term often used to describe the following requirement in paragraph 49 of IAS 39:

> The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

BC66 If a deposit floor were applied in measuring insurance contracts, the resulting measurement would ignore all scenarios other than those involving the exercise of policyholder options in the way that is least favourable to the insurer. Such a requirement would contradict the fundamental proposal to incorporate future cash flows on a probability-weighted basis. It would also move the contract boundary forward to the reporting date. Therefore, the proposals in the draft IFRS would not apply a deposit floor in measuring insurance contracts.

Participation features (paragraphs 62–66)

BC67 Some insurance contracts (participating or 'with profits' contracts) give policyholders the right to share in the experience of a portfolio of insurance contracts, specified assets, or both. The insurer can have contractual discretion over the amount or timing of distributions to policyholders, although that discretion is usually subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. Moreover, at inception of the contract, both the insurer and the policyholder typically expect that distributions will be made unless the performance of the underlying portfolio is significantly worse than expected. Such constrained discretion makes it difficult to determine whether the measurement of the liability arising from these contracts should reflect all cash outflows to policyholders that will arise from the existence of those contracts, including those that are discretionary.

BC68 The discussion paper proposed that for participating contracts, the cash flows for each scenario should include an unbiased estimate of the distributions payable to policyholders in that scenario to satisfy a legal or constructive obligation that exists at the reporting date. Some respondents expressed the view that this test could provide an appropriate answer in their circumstances (although not necessarily in other circumstances), but expressed concerns that the Board's liabilities

project (to amend IAS 37) might narrow the definition of a constructive obligation to the point at which it would not permit an appropriate answer for their circumstances.

BC69 However, most respondents indicated that the measurement of a participating insurance contract should include all cash flows from the contract, without any distinction between the participating and non-participating elements. They said that this would be consistent with the proposal in the discussion paper to select current exit value as the measurement attribute, on the basis that market participants would, in assessing the price for a transfer of the contract, consider all cash flows arising from the contract.

BC70 In line with the comments received and for the following reasons, the Board does not propose to limit the cash flows included in the measurement of the liability to those for which a legal or constructive obligation exists.

(a) Including all the cash flows is consistent with the Board's overall view that the measurement of insurance contracts should deal in the same way with all cash flows arising from the contracts.

(b) It can be exceptionally difficult to determine whether an insurer is paying participating benefits because it believes it is obliged to do so, rather than for some other reason that does not normally justify the recognition of a liability, such as to maintain its competitive position or because it believes it is under some moral pressure. Thus, it could be extremely difficult, and perhaps impossible, to make a reasonable estimate of how much would ultimately be enforceable in the unlikely event that an insurer asserts that its discretion to pay or withhold participating benefits is unfettered.

(c) Distributions to participating policyholders can be viewed as a return of excess premiums. Furthermore, premiums for participating contracts are generally set in the expectation, shared by both parties, that the insurer will pay distributions unless performance ultimately is considerably worse than expected. Therefore, it is appropriate to include those distributions in the measurement on the same expected value basis as the premiums.

(d) The participating feature is inversely related to the fixed benefits for the portfolio as a whole. In some scenarios, the fixed benefits will be high and the participating benefits will be low, whereas in other scenarios the fixed benefits will be low and the participating

benefits will be high. If the measurement excludes some of the cash flows that would occur in some scenarios, the resulting measurement will be less consistent and understandable and will provide less relevant information for users.

(e) At initial recognition, if the cash flows exclude the participating benefits that the insurer estimates it would pay in some scenarios, that exclusion will increase the residual margin. As noted in paragraph BC126, the pattern of income recognition for the residual margin is inherently arbitrary and may not be consistent with the timing of policyholder benefits. In contrast, if the cash flows include for each scenario the estimated participating benefits for that scenario, the residual margin will be smaller and the resulting pattern of income recognition will represent the economics of the transaction more faithfully.

(f) Even if a reasonable estimate of non-discretionary cash flows were possible, investors would not benefit from knowing how much might be enforceable in the highly unlikely event that an insurer tried to avoid paying participating benefits in periods when performance would typically permit such benefits to be paid. That amount provides no information about the amount, timing and uncertainty of future cash flows. On the other hand, investors would want to know:

(i) how much of the cash flows will not be available to investors because the insurer expects to pay them to policyholders. The proposed model conveys that information by including those cash flows in the measurement of the liability.

(ii) how much of the risk in the contracts is borne by the policyholders through the participation mechanism and how much by the investors themselves. This information can be conveyed by the required disclosures about risk.

BC71 Some have expressed concerns that the proposed treatment of participating benefits means that the Board does not attach enough importance to the definition of a liability in the conceptual framework. That is not the case. These benefits arise from one component of a contract that, taken as a whole, clearly meets the *Framework*'s definition of a liability. In the Board's view, requiring insurers to devote exceptional efforts to ascertain whether every single piece of that component (if viewed artificially in isolation) meets the definition of a liability would not generate more relevant and representationally faithful information for users and would impose unjustifiable costs.

BC72 Some have expressed concerns that the proposed treatment of participating benefits could lead to a conclusion that preference shares should be classified as liabilities, or might lead to structuring opportunities if entities embed preference shares in insurance contracts. However, the Board notes some significant differences between preference shares and the participating feature in an insurance contract:

(a) The participating feature in an insurance contract is an integral component of a single instrument and is inversely related to the fixed benefits for the portfolio as a whole. If one is high, the other tends to be low. There is no such relationship for preference shares, which are stand-alone instruments.

(b) Preference shares generally confer a right to share in distributions on liquidation and to receive dividends, if declared, during the life of the entity. In contrast, although participating insurance contracts confer a right to share in distributions, if made, this right expires when the contract matures.

BC73 Some participating insurance contracts are issued by mutual insurers and others are issued by investor-owned insurers. The Board has identified no reason to adopt different treatments for these contracts depending on the legal form of the issuer.

BC74 Some respondents to the discussion paper asked the Board to provide specific guidance on amounts that have accumulated over many decades in participating funds and whose 'ownership' may not be attributable definitively between shareholders and policyholders. The Board does not propose such guidance. The proposals would require an insurer to estimate the cash flows in each scenario. If that requires difficult judgements or gives rise to unusual levels of uncertainty, an insurer would consider those matters in determining what disclosures it must provide to satisfy the proposed disclosure objective.

BC75 As described in paragraphs BC198–BC203, the Board proposes that the IFRS should apply to investment contracts with discretionary participation features.

Embedded options and guarantees

BC76 Insurance contracts contain many embedded options and guarantees, for example:

(a) guarantees of minimum investment returns, minimum interest rates or minimum crediting rates, minimum annuity rates or guarantees of maximum charges for mortality.

(b) surrender options, conversion options or options to cease or suspend payment.

(c) options for the policyholder to reduce or extend coverage, or buy additional coverage.

BC77 Inconsistent treatment of embedded options and guarantees was a major flaw in many traditional accounting models. The flaws included:

(a) ignoring the time value of some or all embedded options and guarantees. The time value of such an item is the value arising from the possibility that the option or guarantee may be in the money at the time when it has an effect (eg when the option is exercisable).

(b) capturing the intrinsic value of some or all embedded options or guarantees on a basis that reflects management's expectations or hopes but is inconsistent with current market prices. The intrinsic value of such an item reflects the extent to which the option or guarantee is in the money at the measurement date, and reflects the difference between the current level of the variable underlying the option or guarantee and the level specified in the underlying option or guarantee.

(c) ignoring the intrinsic value of some or all embedded options or guarantees.

BC78 Over the last few years, many accounting approaches for insurance contracts have been adjusted to capture both the intrinsic value and time value of some embedded options or guarantees by requiring insurers to reflect some of these items, generally by accounting for these embedded guarantees or options as if they were free-standing derivatives (an approach often described as bifurcation or unbundling). However, bifurcation approaches often encounter the drawbacks mentioned in paragraph BC41.

BC79 The proposed measurement model for insurance contracts ensures that embedded derivatives are measured in substantially the same way, regardless of whether they are bifurcated, because it achieves the following:

(a) consistency of financial variables (eg discount rates and equity market prices) with observable market prices. The measurement of some embedded derivatives, particularly embedded derivatives that would be bifurcated under existing requirements, relies heavily on

market inputs (eg guaranteed return on an equity index). Consistency with observable market prices is also consistent with the notion of a replicating portfolio (see paragraphs B45–B47).

(b) capturing both the intrinsic value of options and their time value, by using expected values that capture the cash flows arising in each scenario.

(c) inclusion of a risk adjustment. Market valuations of financial instruments reflect the degree of risk associated with the instrument. Including a risk adjustment is conceptually consistent with that fact.

(d) recognising in profit or loss changes in the carrying amount of the derivatives.

BC80 Other factors, for example non-market variables and non-performance risk, are unlikely to cause significant differences between the fair value of embedded derivatives and the result of applying the proposed measurement model for insurance contracts.

BC81 In some cases, some of the cash flows arising from an insurance contract have a risk profile that resembles the risk profile of a free-standing derivative. Sometimes, the most practical way to capture those cash flows in the measurement is to use a replicating portfolio techniques (see paragraphs B45–B47 and BC97). The resulting measurement is unlikely to differ materially from a measurement at fair value.

BC82 The Board concluded that, as part of a consistent approach to unbundling, an insurer should unbundle embedded derivatives that are not closely related to the insurance coverage, applying the existing bifurcation guidance in IAS 39 (see paragraph 12 and paragraphs BC210–BC225 on unbundling).

Changes in the estimates of future cash flows

BC83 The Board concluded that an insurer should recognise the effect of changes in the estimates of cash flows immediately in profit or loss, rather than:

(a) in other comprehensive income (see paragraphs BC171–BC183 for a discussion of other comprehensive income), or

(b) by adjusting the residual margin, as discussed in the following paragraphs.

BC84 The Board considered whether the residual margin should be adjusted when there are changes in the estimates of financial market variables, such as discount rates and equity prices. If the assets backing insurance liabilities are measured at fair value, there would be an accounting mismatch if the residual margin were adjusted for those changes. Therefore, the Board proposes that changes in estimates of financial market variables should be recognised as income or expense. For the same reason, most respondents to the discussion paper agreed that such changes should be recognised as income or expense.

BC85 The Board considered the following approaches to accounting for changes in other estimates, for example mortality rates, lapse rates and expenses:

(a) The changes are recognised immediately in profit or loss and as an adjustment to the insurance liability. The residual margin is unchanged.

(b) The residual margin is adjusted for the changes, both increases and decreases, and the total liability remains unaffected. No expense is recognised.

BC86 Some believe that it would not be a faithful representation of the profit the insurer earns over the time if an insurer recognises income or expense in one period only to reverse it in a later period. They further believe that reporting changes in estimates could be achieved by disclosing period-to-period changes in that margin. Accordingly, those holding this view believe that the residual margin should be adjusted for changes in estimates of non-financial variables. In addition, some believe it is inconsistent to prohibit the recognition of gains at initial recognition on the basis of estimates, but require the subsequent recognition of gains on the basis of similar estimates.

BC87 However, the Board concluded that a current measure of the insurance liability is integral to understanding and reporting insurance contracts. The immediate recognition of all changes in estimates provides important information to users about changes in circumstances for insurance contracts. The Board also concluded that the usefulness of that information is enhanced by presenting changes in estimates as separate items in profit or loss (see paragraphs BC157–BC188). In this respect, disclosure of the changes in estimates is not an adequate substitute for recognising those changes in profit or loss.

Time value of money (paragraphs 30–34)

BC88 This section discusses the following:

(a) Should the measurement of all insurance contracts reflect the time value of money (paragraphs BC89–BC94)?

(b) Should asset-based discount rates be used (paragraphs BC95 and BC97)?

(c) Should the discount rate for an insurance liability reflect liquidity factors (paragraphs BC98–BC104)?

Time value of money for all insurance contracts?

BC89 Entities are not indifferent to the timing of cash flows. An amount payable tomorrow is not equivalent to the same amount payable in ten years. In other words, money has a time value. The Board proposes that the measurement of all insurance contracts should reflect the time value of money, because that more faithfully represents the insurer's financial position.

BC90 Some respondents to the discussion paper suggested that insurers should not discount their non-life (property and casualty) insurance contract liabilities. In their opinion, measuring non-life insurance contracts at a discounted amount would produce information that is less reliable because non-life insurance contracts are more uncertain than life insurance contracts with respect to:

(a) whether the insured event will occur (whereas the insured event in a life insurance contract is certain to occur unless the policy lapses);

(b) the amount of the future payment that would be required if an insured event occurs (whereas the amount of the future payment obligation is generally specified in, or readily determinable from, a life insurance contract); and

(c) the timing of any future payments required because of the insured event (whereas the timing of future payments in a life insurance contract is typically more predictable).

BC91 These uncertainties mean that the cash flows for many non-life insurance contracts are less predictable than for many life insurance contracts. Those commentators believe that estimating the timing of payments and determining a discount rate would introduce additional subjectivity to the liability measurement, and that this could reduce comparability and

permit earnings management. Furthermore, they believe that the benefits of presenting a discounted measure of those insurance liabilities may not justify the costs to prepare that measurement. They believe that the timing of cash flows (and, therefore, interest) is an essential component of the pricing and profitability of life insurance contracts, but is less relevant for non-life insurance contracts because the commentators view underwriting results as the most critical component of the pricing and profitability of those contracts.

BC92 These arguments did not persuade the Board. As noted in paragraph BC89, insurers and investors are not indifferent to the timing of cash flows, and so measuring an insurance liability using undiscounted cash flows would not faithfully represent the insurer's financial position and would be less relevant to users. The Board also concluded that:

(a) discount rates and the amount and timing of future cash flows can generally be estimated in a sufficiently reliable and objective way at a reasonable cost. Absolute precision is unattainable, but it is also unnecessary. Discounting can be applied in a way that leads to measurements within a reasonably narrow range and results in more relevant information for users. Furthermore, many entities have experience in discounting, both to support investment decisions and to measure items for which IFRSs require discounting (eg employee benefit obligations and long-term non-financial liabilities).

(b) in some cases, discounted measures may be more reliable, and less subjective, than undiscounted measures. When measurements include the effect of inflation explicitly or implicitly, insurers need to estimate the timing of payments. The effect of the time value of money tends to offset much of the effect of inflation, and variations in estimates of cash flows far in the future are smaller when reduced to their present values.

BC93 Some commentators suggested that measuring non-life insurance contract liabilities at undiscounted amounts that ignore future inflation could provide a reasonable approximation of the value of the liability (especially for short-tail liabilities), and at less cost and complexity than explicit discounting. However, this approach of implicitly discounting the liability makes the unrealistic assumption that two variables (claim inflation and time value) will more or less offset each other in every case. For that reason, the Board concluded that financial reporting will be improved if insurers estimate those effects separately.

BC94 For cost-benefit reasons, the Board proposes a modification to the measurement approach for application to the pre-claims period of some short-duration insurance contracts. This is discussed in paragraphs BC145–BC148.

Asset-based discount rates

BC95 Some existing accounting approaches discount insurance liabilities using discount rates derived from the expected return on assets backing the liabilities. Proponents of that technique believe that:

(a) it is consistent with some pricing practices;

(b) it prevents large losses at inception for some contracts that are expected to be profitable and so reflects the most likely outcome of the insurance activity as a whole, considering the underwriting and investment functions together; and

(c) it avoids the volatility that would arise if short-term fluctuations in asset spreads affect the measurement of the assets, but not the measurement of the liabilities. Because an insurer holds those assets for the long term to enable it to fulfil its obligations under the insurance contracts it has issued, some believe that those fluctuations make it more difficult for users of an insurer's financial statements to assess the insurer's long-term performance.

BC96 However, the Board rejected asset-based rates because those rates are irrelevant for a decision-useful measurement of the liability, unless the cash flows from the assets affect the cash flows arising from the liability.

BC97 The cash flows from assets affect the cash flows arising from the liability in unit-linked and some participating contracts. In those cases, the Board believes that an insurer would capture that linkage by using replicating portfolio techniques, or techniques that have similar outcomes (see paragraph 32). A replicating portfolio is a portfolio of assets providing cash flows that exactly match the cash flows from the liability in all scenarios. If such a portfolio exists, the appropriate discount rate(s) for the replicating portfolio would also be the appropriate discount rate(s) for the liability. If a replicating portfolio exists and can be measured directly, there is no need to use a building block approach for the part of the liability that is replicated by that portfolio. The measures of the replicating portfolio and the replicated cash flows arising from the liability are identical.

Liquidity

BC98 Discussions of the time value of money often use the notion of risk-free rates, generally described as observable market rates for highly liquid government bonds. However, there is an important difference between such bonds and many insurance liabilities. Government bonds are often traded in highly liquid markets and the holder often can sell such bonds in the market at short notice, without incurring significant costs and without affecting the market price. In contrast, for many insurance contracts, the policyholder cannot sell the contract to a third party and cannot put it back to the insurer, or perhaps can do so, but only by paying a significant penalty.

BC99 Said differently, the holder of a typical government bond acquires two things, a holding in an underlying non-tradable investment (paying a return higher than the observed return on the traded bond) and an embedded option to sell the investment (for which the holder pays an implicit premium through a reduction in the overall return). Thus, for a liability that the holder cannot sell or put (or can do so only at significant cost), the discount rate should equal the return on the underlying non-tradable investment, with no deduction for the premium on the embedded put option, because no such put option is present in the liability.

BC100 The Board concluded that, in principle, the discount rate should reflect the liquidity characteristics of the item being measured. The Board then considered input from preparers of financial statements, academics and regulators on how such a liquidity premium can be measured.* That input suggests that there is not yet a consensus on how best to measure those effects, for example how to separate liquidity effects from credit effects. Concerns about those issues became greater during the financial crisis of recent years, as spreads widened dramatically.

BC101 The Board believes that it would not be appropriate, in a principle-based approach:

(a) to provide detailed guidance on how to estimate liquidity adjustments.

(b) to prescribe a discount rate that ignores the liquidity characteristics of the item being measured or uses an arbitrary benchmark (eg high quality corporate bonds) as an attempt to develop a practical proxy for measuring the specific liquidity characteristics of the item being measured.

* See for example Committee of European Insurance and Occupational Pensions (CEIOPS) Task Force on the Illiquidity Premium (2010): Report. Ref. CEIOPS-SEC-34/10, 1 March 2010.

BC102 In developing the draft IFRS, the Board considered concerns raised by some commentators about the discount rate, particularly for long-duration non-participating insurance contracts. Those concerns include the following items mentioned in paragraph BC95:

(a) the possibility of significant losses at the inception of some contracts.

(b) possible accounting mismatches if the discount rate for insurance contracts does not change in response to changes in market credit spreads.

BC103 The Board discussed whether those concerns would diminish if the Board revisited its previous decision that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer. After the discussion, the Board did not change that decision but would welcome views on this issue.

BC104 As noted above, there are some difficult conceptual and practical issues relating to the discount rate for insurance contracts. The Board intends to continue its investigation of these issues during the period for comment on the exposure draft. Among other things, the Board intends to seek further input from the insurers that have participated in the field testing exercise.

Depicting risk and uncertainty

BC105 In the draft IFRS, the Board proposes to depict the risk and uncertainty inherent in insurance contracts by including a risk adjustment in the measurement of those contracts. The risk adjustment directly measures the remaining risk in the contract. The measurement of an insurance contract also includes a residual margin (see paragraphs BC124–BC133) to depict the profitability of the contract over time. The residual margin is determined at inception and is calculated as an allocated amount of the consideration received or receivable from the policyholder. This approach of including both a risk adjustment and a residual margin in the measurement of an insurance contract can be referred to as a 'two-margin' approach.

BC106 The FASB and some Board members would prefer to depict risk and uncertainty in the insurance contract within a single composite margin. They consider that the relative benefits of the two-margin approach over a composite margin approach (explained below in paragraphs BC109–BC115) do not outweigh the additional costs of implementation. As explained in

the Appendix, the main difference between the approaches is that, in contrast to the two-margin approach, the composite margin would not identify a separate, explicit risk adjustment in the measurement of an insurance contract.

BC107 Both the two-margin approach and the composite margin approach have advantages and disadvantages. Consequently, the Board would particularly welcome views from respondents on both approaches and will continue its discussions when it is finalising the proposed IFRS.

Risk adjustment (paragraphs 35 and 37)

BC108 This section discusses:

(a) the reasons for including a risk adjustment in the measurement of an insurance contract.

(b) the techniques for estimating the risk adjustment.

(c) the level of aggregation for risk adjustments.

Reasons for including a risk adjustment in the measurement of an insurance contract

BC109 The draft IFRS proposes that the risk adjustment should depict the maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. In the Board's view, the resulting measurement would:

(a) convey useful information to users about the amount of risk associated with the insurer's insurance contracts because the management of risk is integral to the insurance business model.

(b) reflect the insurer's view of the economic burden imposed on it by the presence of that risk.

(c) be broadly consistent with existing requirements in IAS 37, and with the refinements of, and extensions to, those requirements proposed in the exposure draft *Measurement of Liabilities in IAS 37*.

(d) reduce the amount of the residual margin for which a release pattern is somewhat arbitrary.

BC110 The Board thinks that a risk adjustment should not represent:

(a) the compensation a market participant would require for bearing the risk associated with the contract. As noted in paragraphs BC49 and BC50, the objective of the measurement model is not current

exit value or fair value and therefore does not reflect transfer to a market participant. Therefore, the risk adjustment should not be determined as the amount of compensation a market participant would require.

(b) an amount that would provide a high degree of certainty that the insurer would be able to fulfil the contract. Although such an amount might be appropriate for regulatory purposes, it is not compatible with the Board's objective of providing information that will help users of financial statements make economic decisions.

BC111 Some oppose the inclusion of a risk adjustment in the present value of fulfilment cash flows, for the following reasons:

(a) No single technique for developing risk adjustments is universally used and accepted. The co-existence of a range of methods would limit comparability across insurers.

(b) Some techniques are difficult to explain to users and, for some techniques, it may be difficult to provide clear disclosures that would give users an insight into the inner workings of the technique.

(c) Although practitioners may, in time, develop intuitions that help them assess whether the amount of a risk adjustment is appropriate for a given fact pattern, it is not possible to perform direct back-tests to assess retrospectively whether a particular adjustment was reasonable. Over time, an insurer may be able to assess whether subsequent outcomes are in line with its previous estimates of probability distributions. However, it would be difficult, and perhaps impossible, to assess whether, for example, a decision to set a confidence level at a particular percentile was appropriate.

(d) Developing systems to determine risk adjustments will involve cost, and some doubt whether the benefits will be sufficient to justify the cost.

(e) The inclusion of an explicitly measured risk adjustment is inconsistent with the Board's proposals on revenue recognition, whereas the use of a single composite margin is more consistent with those proposals.

(f) If the remeasurement of the risk adjustment for an existing portfolio of contracts results in a loss, that loss will reverse in later

periods as the insurer is released from that risk. Reporting a loss followed by an inevitable reversal of that loss may confuse some users.

BC112 However, the Board proposes to require a separate risk adjustment because it believes that this:

(a) results in an explicit measurement of risk that will provide a clearer insight into the core activity of an insurer.

(b) reduces the amount that needs to be released to income using the inherently somewhat arbitrary mechanisms used to release the composite or residual margin.

(c) is conceptually consistent with market valuations of financial instruments and their pricing, which indisputably reflect the degree of risk associated with the instrument.

(d) ensures that the measurement of an insurance liability includes a margin, which is essential to distinguish risk-generating liabilities from risk-free liabilities. In contrast, a single composite margin reflects the insurer's pricing policy and may not correspond to the degree of risk present in the liability both at inception and throughout the contract term.

BC113 There is an important conceptual difference between the two approaches. The composite margin and the residual margin that the draft IFRS would include in the measurement of an insurance contract are both allocations of an amount determined at inception, and they decline over time in accordance with a specified release pattern (see paragraphs BC125–BC129). In contrast, the risk adjustment is an explicit remeasurement at the end of each reporting period and can, in principle, either increase or decrease at the end of each period.

BC114 However, that conceptual difference will not always have a large practical effect. This is because the risk adjustment will typically decline over time (although, on occasion, it may increase temporarily, for example if a life insurer is uncertain whether a rise in influenza rates reflects normal seasonal variation or the early signs of a pandemic). When that is the case, the two-margin approach (risk adjustment and a separate residual margin) has an effect similar to splitting the initial margin into two components and using a different driver to release each component to income. The resulting release pattern is more sensitive to the economic drivers of the contract, but implementing that approach may be more costly.

BC115 The two-margin approach has one other important practical consequence. That approach is more likely to generate a loss at the initial recognition of an insurance contract. For example, suppose that the expected present value of the net cash flows over the coverage period is a net cash inflow of CU100 (resulting from premium inflows with an expected present value of CU1,000 and policyholder benefit outflows with an expected present value of CU900) and the risk adjustment is CU130. Under the two-margin approach, the insurer would recognise a loss of CU30 at inception. Subsequently, the insurer would recognise income of CU130. In contrast, under the composite margin approach, the initial measurement of the contract would include a composite margin of CU100 and the insurer would recognise no loss at inception. Subsequently, the insurer would recognise income of CU100.

Techniques for estimating the risk adjustment

BC116 The Board proposes to limit the number of permitted techniques to determine the risk adjustment. The Board selected three techniques that it believes are reasonably widely understood, applied in practice to some extent, and capable of providing relevant information consistent with the proposed objective for the risk adjustment. The Board considered the view that:

(a) limiting the number of techniques would conflict with the Board's wish to set principle-based standards.

(b) in particular situations, some techniques may be more applicable, or may be easier to implement. It may not be practicable for an IFRS to specify in detail every situation in which particular techniques would be appropriate.

(c) techniques may evolve over time. Specifying particular techniques might prevent the use of new techniques that are more suitable.

BC117 However, the Board concluded that permitting a wide range of techniques to determine the risk adjustment could lead to diversity in practice, which might reduce the relevance of the resulting measurement and make it difficult for users to compare risk adjustments made by different insurers. Accordingly, the draft IFRS proposes:

(a) to state a principle for determining the risk adjustment.

(b) to specify that only three techniques are permitted as a means of complying with that principle, and to provide guidance to help insurers assess when each of those techniques is more likely to be appropriate.

(c) that an insurer should translate its risk adjustments into a confidence level for disclosure, even if the insurer has used one of the other two permitted techniques to determine the risk adjustment. That disclosure would enhance comparability among insurers.

Level of aggregation for risk adjustments

BC118 Each of the permitted techniques for measuring risk adjustments builds on a probability distribution of the underlying cash flows. The shape of that distribution depends on the level at which the insurer determines the risk adjustments (eg for a contract, for a portfolio, for a legal entity or for the reporting entity as a whole). Therefore, the Board proposes to specify the level of aggregation for the risk adjustment.

BC119 The Board considered the following levels of aggregation:

(a) Determining risk adjustments at the level of individual contracts. However, this approach would contradict the rationale of insurance, which is to pool risks by grouping similar contracts into a portfolio.

(b) Determining risk adjustments directly for a legal entity or for the entire reporting entity. However, this approach would require the insurer to undertake one of the following:

(i) to assume that all portfolios within that entity are fungible, ie that a surplus in one portfolio is available in full to cover a deficit in another portfolio. In the Board's view, this would be inappropriate because complete fungibility is rare in practice, for legal and regulatory reasons.

(ii) to consider the degree of fungibility in estimating the probability distribution. In the Board's view, this would be a difficult and burdensome exercise and would be so reliant on difficult judgements that it would not produce information that is relevant or represents faithfully the degree of fungibility that exists.

(c) Determining risk adjustments at the level of individual portfolios. The Board concluded that this is the most practical solution and the most likely to produce relevant information for users at reasonable cost. Because the portfolio contains reasonably homogeneous contracts, it is the most natural level at which to estimate the probability distribution of the cash flows. Furthermore, although an insurer might expect to derive some

diversification benefits by grouping together various portfolios, determining the extent of those benefits is difficult because of the lack of full fungibility between portfolios.

BC120 In view of the above considerations, the Board proposes that an insurer should determine risk adjustments for a portfolio of contracts that are subject to broadly similar risks and managed together as a single pool. The Board acknowledges that this description of a portfolio is not fully rigorous, but it believes that a more rigorous definition is not attainable and that this description will provide information that is relevant to users and faithfully represents the extent of risk, at a reasonable cost.

Day 1 gains

BC121 The residual margin is calibrated at inception to an amount that precludes the recognition of a net gain at initial recognition of an insurance contract. A 'day 1' gain might arise when the expected present value of cash outflows required to fulfil the insurance contract is less than the expected present value of the consideration received or receivable. However, the Board concluded that an insurer should not recognise a day 1 gain because:

(a) it would be inconsistent with the proposals in the exposure draft *Revenue from Contracts with Customers*. At inception, the insurer has not satisfied any of its performance obligations.

(b) there may be a risk that the amount identified as a day 1 gain has been identified incorrectly, and has arisen from an error in measuring the insurance contract liability.

Day 1 losses

BC122 The Board noted that a loss could arise at contract inception. The Board believes that recognising a loss at inception is appropriate if the amount paid by the policyholder is insufficient to cover the expected present value of the policyholder benefits and claims and also to compensate the insurer adequately (as measured by the risk adjustment) for bearing the risk that the policyholder benefits ultimately exceed the expected premiums paid by the policyholder. The residual margin is an allocation of part of the premium provided by the policyholder. Because it is an allocation, it cannot be negative, either at inception or subsequently.

BC123 As noted in paragraph BC115, a loss is more likely to arise under the two-margin approach than under the composite margin approach. Furthermore, including a risk adjustment in identifying a loss at initial recognition is inconsistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, but it is consistent with the treatment of financial instruments issued on off-market terms. The Board believes that including a risk adjustment in the measurement of insurance contracts is essential to portray the economics of insurance contracts.

Residual margin

BC124 This section discusses the following:

(a) the release to income of the residual margin.

(b) the level of aggregation for the residual margin.

(c) accretion of interest on the residual margin.

Release of residual margin (paragraph 50)

BC125 The residual margin could be viewed as an aggregation of several factors, including:

(a) compensation for the cost and effort of originating the contracts and assembling them into the portfolio.

(b) compensation for providing ancillary services that are not unbundled (and so are not treated as arising from a separate service contract within the scope of standards on revenue recognition).

(c) compensation for product development.

(d) additional returns if the insurer has significant pricing power, or conversely discounts if the insurer is seeking to build or maintain market power.

(e) the risk that the insurer might not satisfy its obligation to perform under the contract.

BC126 The draft IFRS does not propose that an insurer should measure any of those factors separately. Instead, the Board's objective is to seek a release pattern that corresponds in a reasonable way and at an acceptable cost to the pattern of the factors that generated those margins at initial recognition. Because those margins are a blend of various factors not separately identifiable, any such release pattern inevitably will be

arbitrary to some extent. Because the risk adjustment reflects the risk in the contract, the Board thinks that risk should not drive the release pattern for the residual margin (unless risk is used as a convenient and reasonable proxy for another factor).

BC127 Instead, the Board proposes to determine the release pattern for the residual margin on the basis of an insurer's performance under the contract. Since insurance risk is present in every insurance contract and the insurance coverage from this type of risk represents a predominant factor for the performance under the insurance contract, the Board believes that the insurance coverage can be used as the basis for release across all types of contracts.

BC128 The Board believes that the factors implicitly included in the margin would no longer be relevant after the end of the coverage period. Therefore, the Board proposes that the residual margin should be recognised as income over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of passage of time, but

(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

BC129 The draft IFRS proposes that the residual margin recognised in profit or loss for the period should be adjusted to reflect the portion of any contracts that are no longer in force at the end of the reporting period. This is consistent with recognising the residual margin over the coverage period of a contract. For similar reasons, no adjustment should be made if more contracts than expected are in force at the end of the period.

Level of aggregation for the residual margin

BC130 Paragraph BC120 explains that the risk adjustment should be determined at a portfolio of contracts level that groups together contracts subject to similar circumstances (ie contracts that are subject to similar risks and are managed together as a pool). However, because the residual margin is released over the coverage period, it is necessary to adopt a different level of aggregation for residual margins that group together only those contracts within the portfolio that have similar coverage periods. For that reason, the Board concluded that residual margins should be determined at a level that aggregates insurance contracts into a portfolio

and, within each portfolio, by similar date of inception of the contract and by similar coverage period. An alternative would be to determine the release of the residual margin at an individual contract level, but the Board concluded that would be impracticable.

Accretion of interest on the residual margin (paragraph 51)

BC131 Interest is accreted on a risk adjustment because the adjustment is always a current measure and so implicitly or explicitly reflects the time value of money. The draft IFRS proposes that interest also should be accreted on the residual margin for the following reasons:

(a) At initial recognition, the residual margin can be viewed as an allocation of part of the transaction price, ie consideration paid or payable by the insurer's customer (the policyholder). Accreting interest is consistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, which would require an entity to accrete interest on the transaction price (if material). The accretion of interest reflects the fact that the entity would rationally have charged a different cash amount if the contract had stipulated earlier or later payment by the customer. Thus, accretion of interest shows the effect of the financing separately from the revenue from goods or services.

(b) The residual margin is one part of an overall measure of the insurance contract and every other component of that measure reflects the time value of money, leading to subsequent accretion of interest. The accretion of interest on the residual margin is consistent with that fact.

BC132 Because the residual margin is determined at inception and not adjusted subsequently, the Board proposes that the interest rate used to accrete interest on the residual margin would be locked in at inception of the contract and not adjusted subsequently. Furthermore, the rate would be the discount rate used to discount the cash flows included in the measurement of the liability.

BC133 The Board considered the view of some who do not believe interest should be accreted on the residual margin, on the grounds of simplicity and because they view the residual margin as a deferred credit rather than as a representation of a component of an obligation. That view is supported by the FASB and applied to the composite margin in the FASB's preferred approach (see Appendix). However, the Board did not find that view persuasive.

Other measurement issues

BC134 The draft IFRS also contains proposals for the treatment of:

(a) acquisition costs.

(b) insurance contracts acquired in a portfolio transfer or business combination.

(c) the pre-claims liability of short-duration contracts.

(d) foreign currency.

Acquisition costs (paragraph 39)

BC135 Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract. These costs are commonly referred to as acquisition costs. An insurance contract is generally priced to recover those costs through future premiums and surrender charges.

BC136 The measurement approach proposed in the discussion paper and in the draft IFRS represents a change from many existing accounting models that measure insurance liabilities initially at the amount of the premium received, with deferral of acquisition costs. Such models treat acquisition costs as representing the cost of a recognisable asset, which, depending on the model, might be described as a contract asset or a customer relationship intangible asset. The Board thinks that the pressure to recognise such an item as a separate asset arises from an overstatement of the insurer's obligation. In essence, the insurer typically charges the policyholder a price that the insurer regards as sufficient to compensate it for two things: (a) undertaking the obligation to pay for insured losses and (b) the cost of originating the contracts. Thus, a faithful representation of the remaining obligation should not include the part of the premium that paid for the incremental acquisition costs.

BC137 In addition, deferring acquisition costs as an asset would report an asset that either (a) does not exist (if the insurer recovers acquisition costs from cash already received) or (b) relates to future cash flows that should be included in the measurement of the contract. Consequently, the discussion paper proposed that an insurer should recognise acquisition costs as an expense, not as the cost of an asset, and should recognise revenue at an amount equal to the portion of the premium that relates to recovering its acquisition costs. Respondents generally agreed that acquisition costs should not typically result in a loss at initial recognition of an insurance contract (unless the contract is onerous).

BC138 In subsequent discussions, the Board achieved a similar outcome, but by a different route. The Board now proposes that the incremental acquisition costs incurred by the insurer should be included in the contract cash outflows. This reduces the residual margin at initial recognition of the contract. If the contract pricing is insufficient to recover all of the incremental acquisition costs, a loss will arise at initial recognition, because the residual margin cannot be negative.

BC139 The Board proposes that the contract cash flows should include only those acquisition costs that are incremental to an individual insurance contract. Some may disagree with that conclusion because they believe that:

(a) an insurer typically will price an insurance contract to recover not only incremental costs, but also other direct costs and a proportion of indirect costs; and

(b) the definition of incremental acquisition costs is too narrow to reflect adequately the various sales structures of insurers—for instance, it may result in different answers for sales structures that have the same cost level but use different channels (eg external agents versus direct writing).

BC140 The Board proposes to limit the acquisition costs to be included in the cash flows to incremental costs because those costs can be clearly identified as relating specifically to the contract. Determining whether other costs are directly related to the contract can be more subjective. Furthermore, focusing on incremental costs is consistent with how IAS 39 and IFRS 9 determine the transaction costs of financial instruments. It is also consistent with the approach to costs of securing a right to provide investment management services, as described in paragraph 14(b)(iii) of the illustrative examples accompanying IAS 18 *Revenue*. (However, under the proposals in the exposure draft *Revenue from Contracts with Customers*, that right would no longer be recognised as an asset, and the incremental costs of securing it would be recognised as an expense.)

Insurance contracts acquired in a portfolio transfer or business combination (paragraphs 40–42)

BC141 When an insurer assumes an insurance liability in a portfolio transfer, it typically receives consideration from the transferor. The Board concluded that the insurer should treat that consideration in the same way as a premium received at initial recognition. In other words:

(a) if the consideration received exceeds the present value of the other fulfilment cash flows (outflows less inflows), the excess establishes the residual margin at initial recognition of the insurance liability.

(b) if the present value of the other fulfilment cash flows (outflows less inflows) exceeds the consideration received, the insurer should measure the insurance liability initially at that higher amount and should not add a residual margin. Instead, the difference between the initial measurement of the liability assumed and the consideration received would be recognised immediately as an expense at initial recognition.

BC142 Similarly, when an entity assumes a liability in a business combination, it measures that liability initially at fair value, with limited exceptions specified in IFRS 3 *Business Combinations*. That fair value may be viewed as representing a portion of the total consideration for the business combination, namely the portion relating to the liability assumed. In other words, the fair value of the portfolio of insurance liabilities may be viewed as corresponding to the fair value of the consideration received. Applying that notion to a portfolio of insurance liabilities assumed in a business combination leads to the following conclusions:

(a) If the fair value of the portfolio exceeds the present value of the fulfilment cash flows (outflows less inflows), the excess establishes the residual margin at initial recognition of the portfolio of insurance liabilities.

(b) If the present value of the fulfilment cash flows (outflows less inflows) exceeds the fair value of the liability, the insurer should measure the portfolio of insurance liabilities initially at that higher amount and should not add a residual margin.

BC143 The proposal described in paragraph BC142(b) means that an insurer would never recognise the portfolio of insurance liabilities at less than the present value of the fulfilment cash flows. Moreover, the initial measurement of that portfolio at that higher amount will affect the initial measurement of goodwill. Although this proposal would require a new measurement exception in IFRS 3, similar exceptions are contained in IFRS 3 for other cases in which liabilities, such as pension liabilities, are measured continuously on a current value basis that is not fair value.

BC144 The Board considered how the present value of the fulfilment cash flows could exceed the consideration received in exchange for a portfolio transfer or might exceed the fair value of the portfolio of insurance contracts acquired in a business combination. The most likely cause is the fact that the present value of the fulfilment cash flows does not

consider the risk of non-performance by the insurer. The Board concluded that the immediate recognition of a loss in such circumstances faithfully represents the fact that the insurer has acquired an obligation that it expects to fulfil, but received a lower price because it might not be able to fulfil the obligation.

Modified measurement for the pre-claims liability of some short-duration contracts (paragraphs 54–60)

BC145 The Board proposes that the pre-claims liability arising from some short-duration contracts (ie contracts for which the coverage period is approximately one year or less, and meeting other conditions specified in paragraph 55) should be measured using an unearned premium approach, unless the contract is onerous. Such an approach is consistent with the customer consideration approach proposed in the exposure draft *Revenue from Contracts with Customers*.

BC146 The Board believes that when the pre-claims period is approximately one year or less and provided that the contract contains no significant embedded derivatives, the unearned premium is a reasonable approximation of the present value of the fulfilment cash flows and the residual margin (and achieves a similar result at a lower cost). This is because if significant changes in estimates are made during the coverage period of a short-term duration contract, those changes are more likely to be unfavourable (leading to losses) than favourable (leading to gains). The insurer would recognise these losses because of the requirement to recognise an additional liability when the contract becomes onerous. Thus, requiring an insurer to apply the full measurement model for these contracts would not generate sufficient benefits to justify the costs of adopting the new approach.

BC147 The Board considered whether the modified approach should be permitted but not required. Proponents of that view argue that the modified approach is intended to provide a practical short cut that combines the strengths of the approach now proposed for insurance contracts in general with the virtues of existing approaches for these contracts; for these contracts, they believe that the incremental benefits of switching fully to the new model are not sufficient to justify the costs. Those proponents argue that requiring insurers to use that short cut rather than merely permitting them to do so is inconsistent with the rationale for the short cut. However, to ensure comparability between the financial statements of different insurers, the Board proposes to require insurers to apply the modified measurement approach to all short-duration contracts that meet the specified conditions.

BC148 To maintain consistency with the measurement for insurance contracts generally, the modified approach also includes the following features:

(a) The pre-claims obligation and the expected present value of the future premiums are presented as a single insurance contract asset or liability (see paragraph BC156).

(b) Interest is accreted on the insurance contract asset or liability, if the effect of the time value of money is material.

(c) The basis for the onerous contract test is the present value of the fulfilment cash flows, which is the measurement for insurance contracts generally. Considering the short duration of the coverage period, the level of aggregation for the onerous contract test would be within the portfolio of insurance contracts, by similar date of inception.

(d) The incremental acquisition costs are deferred and presented as a deduction from the part of the premium allocated to the remaining coverage period. Those deferred incremental acquisition costs would be recognised as an expense over time in a pattern consistent with the pattern in which the premium is recognised as revenue.

Foreign currency (paragraph 61)

BC149 The draft IFRS proposes that an insurance contract should be treated as a monetary item for foreign currency translation in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

BC150 Insurers applying IFRS 4 typically treat an unearned premium for an insurance contract that is denominated in a foreign currency as a non-monetary item. However, treating the unearned premium as a non-monetary item causes an accounting mismatch to arise if, for example, the premium is held in a bank account denominated in foreign currency (and thus is classified as a monetary item) and the insurer expects to use part of that premium to pay claims denominated in that foreign currency. In that example, the carrying amount of the premium would reflect subsequent changes in the exchange rate, whereas the carrying amount of the non-monetary insurance liability would remain unchanged. The Board believes that because the proposed measurement model focuses on estimates of future cash flows, it would be more appropriate to view an insurance contract as a whole as a monetary item.

BC151 IAS 21 would classify the insurance contract components relating to the expected present value of cash flows and the risk adjustment (which is determined by the amount, timing and uncertainty of those cash flows) as monetary items, but might classify the residual margin component as non-monetary because it is similar to prepayments for goods and services. However, the Board believes that it would be a more faithful representation of the transaction to treat all components of the measurement of insurance contract denominated in a single currency as a monetary item, and therefore retranslate them as exchange rates change.

BC152 For the same reasons, the Board proposes that insurance contracts measured using the modified approach for short-duration contracts would also be a monetary item.

Assets underlying unit-linked contracts

BC153 The Board discussed accounting mismatches that arise today from the measurement of unit-linked contracts, focusing on the following items held in funds underlying such contracts:

(a) the insurer's own shares. An accounting mismatch arises for these items today because they are not recognised as assets under IAS 32.

(b) property occupied by the insurer. An accounting mismatch arises today for such property because IAS 16 *Property, Plant and Equipment* would treat it as owner-occupied. As a result, although the insurer would be able to measure that property at fair value, it would recognise changes in the property's fair value in other comprehensive income, not in profit or loss.

BC154 The Board concluded that these accounting mismatches make an insurer's financial statements less relevant to users and less understandable, resulting in a less faithful representation of the insurer's financial position and financial performance. Therefore, the Board proposes:

(a) to eliminate those mismatches by requiring the insurer to recognise these items, including the insurer's own shares, as assets and measure them at fair value through profit or loss to the extent those changes relate to the interest of unit-linked contract holders in the pool of assets (see Appendix C to the draft IFRS).

(b) that if the insurer also has its own interest in the same fund, the insurer should measure those assets at fair value. However, in the case of property, changes in the fair value of the insurer's own

interest in the property would be recognised in other comprehensive income as a revaluation.

BC155 To improve comparability, the Board proposes to require that treatment, not merely to permit it. However, the Board does not intend to introduce a requirement for insurers to measure all financial assets underlying unit-linked contracts at fair value through profit or loss, if that would not otherwise be required by IFRS 9 or IAS 39.

Presentation (paragraphs 69–78)

Statement of financial position (paragraphs 69–71)

BC156 The draft IFRS proposes that the combination of rights and obligations arising from an insurance contract is presented as a single insurance contract asset or liability in the statement of financial position, consistently with the measurement of an insurance contract asset or liability based on a package of cash inflows and outflows. Such presentation is consistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, which treat the combination of rights and obligations as giving rise to a single contract asset or liability.

Statement of comprehensive income (paragraphs 72–78)

BC157 The Board proposes a presentation model for reporting income and expense arising from insurance contracts that is consistent with the proposed measurement model by reporting the changes in the building blocks that make up the measurement of the insurance contract. Such a presentation would provide users with useful information about important performance factors. Accordingly, the statement of comprehensive income should provide information about:

(a) the change in the risk adjustment.

(b) the release of the residual margin.

(c) the difference between the actual cash flows for the current period and previous estimates of those cash flows.

(d) changes in estimates (remeasurements) during the period.

(e) interest expense on insurance liabilities (ie the 'unwinding' of the discount), presented or disclosed in a way that highlights the relationship between interest expense, changes in discount rates and investment return on the assets that back those liabilities.

BC158 The Board considered two approaches for presenting income and expenses arising from insurance contracts: a margin approach and a premium approach.

Margin approaches

BC159 A margin approach presents changes in the risk adjustment and the release of the residual margin as important performance measures for an insurer.

BC160 The draft IFRS proposes a margin approach that views all cash inflows associated with an insurance contract as deposits received from the community of policyholders and all the cash outflows as repayments to the community of policyholders. Some refer to this approach as a 'summarised margin approach' because it does not present any items of income or expense relating directly to those cash flows. The draft IFRS proposes enhanced disclosure to provide users with information on premiums, claims and expenses (see paragraph BC167).

BC161 The summarised margin approach follows the structure of the information in paragraph BC158 by separately reporting:

(a) income from the insurer's performance under the contract as it is released from risk (decrease in risk adjustment) and as it provides insurance coverage (release of the residual margin).

(b) changes in circumstances as they occur, and any differences between estimates at the end of the previous reporting period and actual outcomes.

(c) the interest expense on insurance liabilities, presented or disclosed in a way that highlights the relationship with changes in discount rates and with the investment return on the assets that back those liabilities.

BC162 In the Board's view, a summarised margin approach has the following advantages:

(a) It links clearly with the measurement approach for the insurance liability in the statement of financial position. Failure to illustrate such linkages is a significant defect of many existing models, particularly for long-duration contracts.

(b) It makes it unnecessary to unbundle deposit receipts from the premiums because it treats premiums in the same way as deposits. Many longer-term life insurance contracts contain deposit

components. Drawing a line between the deposits and the premiums may be somewhat arbitrary for some contracts.

BC163 However, the summarised margin approach does not provide information in the statement of comprehensive income about the amount of premiums and claims. Most respondents to the discussion paper viewed all premiums as revenue, especially for non-life insurance contracts. Furthermore, the summarised margin approach does not present revenue as defined in the exposure draft *Revenue from Contracts with Customers* because the summarised margin approach depicts as income only part of the total consideration receivable from the policyholder, namely the risk adjustment at initial recognition, and the residual margin. Accordingly, the income presented in the statement of comprehensive income would not be comparable with presentation approaches for revenue from other activities, such as fund management.

BC164 The Board considered an approach that expands the summarised margin approach to provide information about premiums and claims (the 'expanded margin' approach). In the expanded margin approach, the insurer presents in profit or loss both changes in the risk adjustment and the release of the residual margin during the reporting period, and some or all of the policyholder claims and benefits and other expenses.

BC165 However, in some cases, the revenue recognised using the expanded margin approach would not be determinable directly, but would need to be imputed by 'grossing up' the change in margin by some or all of the claims and expenses. The amount presented in profit or loss could be based on estimated claims and expenses determined at inception of the contract, or based on the actual claims and expenses that occurred during the reporting period. Whichever of those approaches is adopted, determining the amount presented in profit or loss could require significant costs (eg those associated with tracking historical information) and could result in amounts in profit or loss that cannot be related in a clear and understandable way to the amounts in the statement of financial position. Therefore, the Board rejected this approach.

BC166 In the Board's view, information about premiums, claims and expenses is relevant to users of financial statements. Therefore, the Board proposes to require disclosure of such information.

Premium approaches

BC167 The Board also considered premium approaches for the recognition of income and expense in profit or loss, as follows:

(a) In a 'written premium' approach, premiums received are presented as revenue when receivable and at the same time the corresponding increase in the liability is presented as an expense. Many existing accounting models apply this approach to life insurance contracts.

(b) Under an approach based on allocation of the premium (or 'earned premium'), premiums received are presented as a pre-claims obligation ('unearned premium') in the statement of financial position (ie as performance obligations). As the insurer performs under the contract by providing insurance coverage, the pre-claims liability is released and recognised in the statement of comprehensive income as premium revenue. Many existing accounting models apply this approach to non-life insurance contracts.

BC168 Supporters of premium approaches believe such approaches provide information about the amount of premiums relating to coverage provided during a period. Many users of financial statements regard such information as a key performance measure for an insurer. However:

(a) for a written premium model, the pattern of premium payments may not reflect the services provided by the insurer during the contract term. Therefore, a written premium approach would be inconsistent with existing practices for recognising and presenting revenue for contracts other than insurance contracts, and with the proposed model in the exposure draft *Revenue from Contracts with Customers.*

(b) as discussed in paragraphs BC22–BC35, allocation of the premium or a part of that premium is inherently challenging for some types of insurance contracts, (eg immediate annuities, stop-loss contracts, and contracts that contain significant guarantees and options).

(c) premium approaches do not reflect changes in the building blocks that make up the measurement of the insurance contract.

BC169 Therefore, the Board does not propose that insurers apply a premium approach for presentation, except for pre-claims liabilities of short-duration contracts that are measured using the modified approach. In the Board's view, for those contracts a presentation approach showing the allocated premium (ie the earned premium) as revenue and incurred claims as an expense would be consistent with the proposed revenue recognition model and would provide users with relevant information that faithfully represents the performance of these contracts.

Combination of a margin approach and a premium approach

BC170 The Board also considered combining a margin approach with a premium approach, by using an explicit measurement of insurance coverage to identify premiums as revenue as the insurer performs under the contract. However, a combined approach would require an insurer to apply two models: the proposed insurance contracts model for liability measurement and the proposed revenue recognition model to determine the amount recognised as revenue. The Board concluded that such an approach would be unduly costly and burdensome. Also, as referred to in paragraph BC168(b), applying an allocation of premiums based on the proposed revenue recognition model can be challenging for some types of insurance contracts.

No presentation in other comprehensive income

BC171 The draft IFRS carries forward the proposal in the discussion paper that all income and expense arising from changes in the carrying amount of an insurance contract asset or liability should be presented in profit or loss. Most respondents to the discussion paper agreed with that proposal. However, some respondents believed that the Board should require or permit insurers to present in other comprehensive income some or all income or expense, for one or both of the following reasons:

(a) to avoid accounting mismatches if assets backing insurance liabilities are not measured at fair value through profit or loss (paragraphs BC172–BC181).

(b) to distinguish short-term market volatility that might reverse over the long term of the insurance contracts from other changes in the carrying amount of the insurance contract asset or liability (paragraphs BC182 and BC183).

Accounting mismatches

BC172 The Basis for Conclusions on IFRS 4 distinguishes two types of mismatches:

(a) An 'economic mismatch' arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. For example, an economic mismatch arises if the duration of insurance liabilities is longer than the duration of fixed interest assets backing those liabilities.

(b) An 'accounting mismatch' arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because different measurement attributes are applied.

BC173 Users and preparers of financial statements and other interested parties have consistently stated that it is important for insurers to account for insurance contracts and related assets in a manner that avoids accounting mismatches. They have noted that it is burdensome for insurers to explain the effects of accounting mismatches even to sophisticated users, and less sophisticated users may be less able to understand these effects. In the discussion paper, the Board expressed the preliminary view that an ideal measurement model would report all economic mismatches and would not create any accounting mismatches.

BC174 A common cause of accounting mismatches for insurers relates to measuring interest-bearing financial assets at fair value when insurance contracts are measured on a basis that does not reflect current interest rates. If interest rates change, the carrying amount of the assets changes but the carrying amount of the insurance liabilities does not, with the following consequences:

(a) For financial assets classified as 'at fair value through profit or loss', there is an accounting mismatch in both the statement of comprehensive income and the statement of financial position.

(b) For measurements of financial assets measured at fair value in the statement of financial position but not in profit or loss (such as 'available-for-sale financial assets' under IAS 39 or equity instruments measured at fair value through other comprehensive income under IFRS 9), there is no accounting mismatch in profit or loss (unless the assets are sold), but there is an accounting mismatch in other comprehensive income and, consequently, also in equity.

(c) If the insurer sells assets, an accounting mismatch occurs not only for available-for-sale financial assets, but also for assets carried at amortised cost.

BC175 In developing the draft IFRS, the Board considered the following approaches to address accounting mismatches for insurers:

(a) changing the accounting for an insurer's assets, or

(b) requiring or permitting an insurer to present some or all changes in its insurance liabilities in other comprehensive income.

BC176 In the Board's view, it would not be appropriate to change the accounting for an insurer's assets, other than assets relating to unit-linked and index-linked insurance contracts, see paragraphs BC153–BC155, because:

(a) other assets and liabilities of an insurer are outside the scope of the draft IFRS.

(b) it would be undesirable to create industry-specific requirements for the accounting for assets. To do so would reduce transparency and perpetuate the barriers that impede communication between insurers and users of their financial statements.

(c) it may not be possible to identify which of the insurer's assets are held to back insurance liabilities and which are not.

BC177 The Board considered whether to require or permit insurers to present in other comprehensive income changes in insurance liabilities backed by assets that are not measured at fair value through profit or loss in accordance with IFRS 9. Assets not measured at fair value through profit or loss include:

(a) financial instruments that are measured at amortised cost in accordance with IFRS 9 (paragraphs BC178 and BC179).

(b) some investments in equity instruments for which IFRS 9 permits gains and losses to be presented in other comprehensive income (paragraph BC180).

Amortised cost

BC178 The Board does not propose to permit or require insurers to present in other comprehensive income changes in the carrying amount of insurance liabilities backed by financial assets that are measured at amortised cost. Such presentation:

(a) might eliminate some or all of the mismatch in profit or loss, but would not eliminate the accounting mismatch from comprehensive income or equity.

(b) would be complex and difficult to understand.

(c) would be onerous for insurers because of the need:

(i) to determine the part of the insurance liability deemed to be backed by assets measured at amortised cost.

(ii) to track 'cost' information for that part of the liability, to achieve the desired split between amounts recognised in profit or loss and amounts recognised in other comprehensive income.

(iii) to determine whether, and when, to recycle amounts from other comprehensive income to profit or loss.

BC179 Furthermore, an insurer could avoid this accounting mismatch by using the fair value option for its assets.

Other comprehensive income presentation alternative for some equity instruments

BC180 The Board does not propose to permit or require insurers to present in other comprehensive income changes in insurance liabilities backed by equity instruments measured at fair value through other comprehensive income because:

(a) an insurer's insurance liabilities may not be fully backed by those equity instruments measured at fair value. Thus, an insurer would report part of the changes in the carrying amount of its insurance liabilities in other comprehensive income and part in profit or loss. The resulting complexity would not be clear, transparent, understandable or informative for users of financial statements.

(b) the requirement would be onerous for insurers because of the need to determine the part of the insurance liability deemed to be backed by equity instruments measured at fair value through other comprehensive income.

(c) presenting changes in fair value of equity instruments in other comprehensive income is optional. Thus, no insurer is required to suffer the mismatch discussed above.

Shadow accounting

BC181 The proposal to present all income and expense from insurance contracts in profit or loss eliminates the need for a practice known as 'shadow accounting'. Shadow accounting has two forms, as follows:

(a) In some accounting models, the measurement of some or all of an insurer's non-participating insurance liabilities depends on realised gains and losses on an insurer's assets. For example, section 944-30-35[*] of FASB ASC Topic *Financial Services – Insurance* requires some insurance liabilities to be measured on the basis of the estimated gross profit, including amounts expected to be earned from the investment of policyholder balances. To eliminate the mismatch between assets measured at fair value through other comprehensive income and unrealised gains and losses, shadow accounting adjusts the insurance liability so that unrealised gains and losses are recognised in the same way as realised gains and losses. The proposals in the draft IFRS do not measure non-participating insurance contracts on the basis of gains and losses on assets. Thus, this application of shadow accounting would no longer be relevant.

(b) When policyholders participate wholly or partly in returns on assets measured at fair value through other comprehensive income, shadow accounting adjusts other comprehensive income to reflect that participation. This form of shadow accounting could be relevant because IFRS 9 permits some equity instruments to be measured at fair value through other comprehensive income. However, IFRS 9 requires that, for such equity instruments, entities recognise only dividend income in profit or loss, with realised and unrealised gains and losses recognised in other comprehensive income. As a consequence, shadow accounting is likely to result in complexity that would not be easy for users to understand or for preparers to apply. Therefore, the Board proposes not to retain shadow accounting (currently permitted under IFRS 4).

[*] originally introduced by SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

Short-term market volatility

BC182 Some respondents to the discussion paper proposed that an insurer should recognise in other comprehensive income changes in the insurance liability arising from changes in financial inputs or market variables. Those respondents believe this approach:

(a) would represent the economics of the insurance business more faithfully than recognising all changes in the carrying amount of the insurance liability in profit or loss because it would distinguish the insurer's longer-term performance from changes they regard as short-term.

(b) permit insurers to present performance on a basis comparable to financial institutions, such as banks, that use amortised cost for some of their financial assets and many of their financial liabilities.

(c) would be consistent with the proposals in the exposure draft *Defined Benefit Plans*, which proposes the use of other comprehensive income to report remeasurements of post-employment benefit liabilities. Some respondents to the discussion paper viewed post-employment benefit liabilities and insurance liabilities, particularly some long-duration life insurance contracts, as having some common characteristics.

BC183 In the Board's view, gains and losses on insurance contracts are a core part of an insurer's performance in both the short term and long term. Therefore, presentation of those gains and losses in profit or loss is appropriate. The Board welcomes comments on how gains and losses from insurance liabilities can be presented in profit or loss in a way that best depicts their relationship with gains and losses from the assets backing those liabilities.

Assets underlying unit-linked contracts (paragraphs 71 and 78)

BC184 Unit-linked contracts are contracts for which some or all of the benefits are determined by reference to the price of units in an internal or external investment fund (ie a specified pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund, sometimes also referred to as 'separate account' in the context of US GAAP).

BC185 For unit-linked contracts, all of the investment performance of the underlying pool of assets is passed to the holders of the contracts. As a result, the shareholders and other policyholders neither benefit nor suffer from that investment performance (except through guarantees of minimum returns in specified circumstances, for example on death or maturity). In contrast, for more 'traditional' types of insurance contracts, actual investment returns do not determine the benefits paid to policyholders.

BC186 In the Board's view, presenting the assets backing unit-linked contracts separately from the insurer's other assets would provide useful information to users of financial statements because those assets do not expose the insurer to the same risks as other assets. Therefore, the Board proposes that for unit-linked contracts an insurer should:

(a) present the pool of assets underlying unit-linked contracts separately from the insurer's other assets. This implies that any interest the insurer holds in the underlying fund for its own account should be presented together with other assets.

(b) the portion of the liabilities from unit-linked contracts linked to the pool of assets in (a) separately from the insurer's other insurance contract liabilities.

BC187 Similarly, the Board proposes that insurers should present single line items for both income and expense from the pool of assets underlying unit-linked contracts and from the portion of the liabilities linked to those assets, separately from income and expense from the insurers' other assets and insurance contract liabilities. Such presentation would reflect the nature of these contracts in a transparent way and provide users of financial statements with information about the insurer's performance on unit-linked contracts. It would also distinguish those investment returns that affect the insurer directly from those investment returns that are contractually passed through to policyholders.

Scope (paragraphs 2–7)

BC188 The Board proposes that the IFRS should apply to insurance contracts and to financial instruments that contain a discretionary participation feature. The draft IFRS does not deal with other assets and liabilities of insurers, nor does it deal with accounting for insurance contracts by policyholders (other than by cedants).

Definition of an insurance contract (Appendix A)

BC189 The draft IFRS proposes that the accounting model would apply to all types of insurance contract: life and non-life, direct insurance and reinsurance. The accounting model would apply throughout the life of a contract, in both:

(a) the pre-claims period (the coverage period when the insurer is standing ready to meet valid claims),* and

(b) the claims handling period (when the insured events have occurred but the ultimate payment is uncertain). For some non-life insurance contracts, the claims handling period can extend for many years. For life insurance, the pre-claims period extends throughout the coverage period, but the claims handling period is generally very short because there is little or no uncertainty about the payment once the insured event has occurred, and payment generally occurs quickly.

BC190 The definition of an insurance contract proposed in the draft IFRS is based on the definition in IFRS 4 (including the related guidance in Appendix B of IFRS 4). In the discussion paper, the Board did not propose a new definition of insurance contract, but proposed to consider whether the definition in IFRS 4 was still appropriate when it developed the draft IFRS, together with considering input from the FASB's project on insurance risk transfer.

BC191 In developing the draft IFRS, the Board compared the IFRS 4 definition with US GAAP requirements to identify possible improvements that could be made to that definition and considered the main differences, as follows:

(a) *use of 'compensation' rather than 'indemnification' in describing the insurance contract benefit.* In the Board's view, these terms have broadly the same meaning. However, describing an insurance contract as compensating the policyholder may be more intuitive in some instances, for example in referring to a death benefit in a life insurance contract that compensates the beneficiary with a specified amount for the loss of the insured's life. Accordingly, the Board retained 'compensation' in the definition of an insurance contract.

* A modified version of the model would apply to the pre-claims period of short-duration contracts, as discussed in paragraphs BC145–BC148.

(b) *the role of timing risk*. US GAAP requires the presence of both timing risk and underwriting risk in an insurance contract, whereas IFRS 4 treats contracts that transfer either underwriting risk or timing risk as insurance contracts. In US GAAP, much of the pressure on the notions of underwriting risk and timing risk arises because the accounting for some insurance contracts does not require insurers to discount the expected future cash flows when measuring the insurance liability. However, that pressure is not present in the model proposed in the draft IFRS. Therefore, the Board does not propose to require the presence of both timing risk and underwriting risk. However, the draft IFRS introduces a proposal that an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario (ie if an insured event occurs) are significant (see paragraph B26).

(c) *the notion of a loss.* When an insurer assesses whether an insurance contract transfers significant insurance risk, IFRS 4 requires the insurer to consider whether an insured event could require significant additional benefits in any scenario that has commercial substance (see paragraph B23 of IFRS 4 and paragraph B24 of the draft IFRS). The Board understands that practice under US GAAP considers whether the present value of net cash outflows can exceed the present value of premiums in any scenario. The Board proposes to import that as an additional test (see paragraph B25 of the draft IFRS). Although the Board has no specific reason to think that the absence of such a test in IFRS 4 has led to misleading classification of contracts, the inclusion of such a test is consistent with the Board's understanding of practice under US GAAP.

BC192 Paragraphs BC11–BC60 of the Basis for Conclusions on IFRS 4 discuss other aspects of IFRS 4's definition of an insurance contract.

Coverage against credit defaults

BC193 IFRSs define a financial guarantee contract as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. These contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract, but their accounting treatment does not depend on their legal form. In phase I of this project, the temporary solution in IFRS 4:

(a) permits insurers to treat these contracts as insurance contracts.

(b) requires other entities to treat them as financial instruments, measured initially at fair value (typically equal to the consideration received), with subsequent amortisation of that amount, coupled with a test for credit losses.

BC194 These contracts transfer credit risk. Some view all contracts that transfer credit risk as financial instruments. However, a contractual precondition for a payment under the contracts described in the previous paragraph is that the holder has suffered a loss—a distinguishing feature of insurance contracts. Therefore, the Board proposes that the definition of an insurance contract should continue to capture these contracts and that they should be within the scope of the draft IFRS. In the Board's view, the proposed accounting model for insurance contracts is equally appropriate for this particular subset of insurance contracts.

BC195 Because contracts meeting the Board's existing definition of a financial guarantee contract also meet the definition of an insurance contract (unless the transfer of insurance risk is insignificant), the proposal to use the proposed insurance contracts model for all those contracts removes the need for the definition of a financial guarantee contract. Thus, it would be withdrawn.

BC196 For some credit-related contracts, it is not a precondition for payment that the holder has suffered a loss. An example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index. Those contracts are derivatives and do not meet the definition of an insurance contract. The issuer would continue to account for them as derivatives.

BC197 Although US GAAP requires issuers of most guarantees to recognise them at fair value, that requirement does not apply to guarantees issued between parents and their subsidiaries, between entities under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent. In 2005 the Board decided not to introduce such an exemption in IFRSs and it does not propose one now. The Board believes that failing to account for liabilities under such guarantees would not provide a faithful representation of the issuer's financial position.

Financial instruments with discretionary participation features (paragraph 2(b))

BC198 The Board proposes that issuers of financial instruments with discretionary participation features ('participating investment contracts') should apply the draft IFRS to those contracts. Although those contracts do not meet the proposed definition of an insurance contract, the Board noted the following advantages of treating participating investment contracts in the same way as participating insurance contracts, rather than as financial instruments:

(a) Participating investment contracts and participating insurance contracts are sometimes linked to the same underlying pool of assets (and sometimes participating investment contracts even share in the performance of insurance contracts). Using the same approach for both types of contract will produce more relevant information for users and simplifies the accounting for those contracts. For example, some cash flow distributions to participating policyholders are made in aggregate for both participating insurance and investment contracts, making it problematic to apply different accounting models to different parts of that aggregate participation.

(b) Both of these types of contracts often have characteristics, such as long maturities, recurring premiums and high acquisition costs, that are more commonly found in insurance contracts than in most other financial instruments. The proposed model for insurance contracts was developed with the specific aim of generating useful information about contracts containing these features.

(c) Participating investment contracts contain a complex package of interdependent options and guarantees (eg minimum guarantees, surrender options, conversion options and paid-up options). Accordingly, some of these features might be separated into components under the Board's current and proposed requirements for financial liabilities. Splitting these contracts into components with different accounting treatments would not be a faithful representation of the package as a whole, resulting in information that is not understandable, and would be burdensome and costly.

BC199 The FASB concluded that these arguments are insufficient to justify excluding these contracts from the scope of its financial instruments standards (see the Appendix).

BC200 In contrast, the Board found the arguments listed in paragraph BC198 persuasive and proposes to apply the draft IFRS to those contracts.

BC201 To identify the participating investment contracts that should be within the scope of the draft IFRS, the Board proposes to use the existing definition of a discretionary participation feature (DPF) in IFRS 4, with one modification to reflect a factor that the Board found particularly persuasive. The amendment would stipulate that the contracts must share in the performance of the same pool of assets as do participating insurance contracts. The Board is not aware of any reason to make any other changes to the definition of a DPF.

BC202 The definition of a DPF plays a less significant function in the draft IFRS than in IFRS 4. In IFRS 4, the definition applies to both participating insurance contracts and participating investment contracts, and it serves to permit specified practices to continue until the Board replaces IFRS 4. In contrast, the only function of the definition of a DPF in the draft IFRS is to define which participating investment contracts are within the scope of the accounting model that is proposed for insurance contracts.

BC203 In addition, because participating investment contracts do not transfer significant insurance risk, the draft IFRS proposes the following modifications to the proposals for insurance contracts (paragraphs 64 and 65 of the draft IFRS):

(a) The contract boundary principle for these contracts builds on the defining characteristic of these contracts, namely the presence of the discretionary participation features, rather than the existence of insurance risk.

(b) The proposed requirement for the release of the residual margin refers to the pattern of provision of asset management services, rather than the pattern of claims and benefits.

Scope exclusions (paragraph 4)

BC204 The draft IFRS proposes to carry forward the following scope exclusions based on IFRS 4:

(a) product warranties issued by a manufacturer, dealer or retailer (see paragraphs BC207 and BC208).

(b) employers' assets and liabilities under employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans (see IAS 19 *Employee Benefits*, IFRS 2 *Share-based Payment* and IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).

(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (see IAS 17 *Leases*, IAS 18 and IAS 38 *Intangible Assets*).

(d) residual value guarantees provided by a manufacturer, dealer or retailer or embedded in a lease (see the exposure draft *Revenue from Contracts with Customers* and the forthcoming exposure draft *Leases*). However, stand-alone residual value guarantees are not addressed by the Board's other projects and would remain within the scope of the insurance IFRS.

(e) fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event (see paragraphs BC209 and BC210).

(f) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).

(g) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the *policyholder*).

BC205 In addition, the draft IFRS does not address accounting for insurance contracts by policyholders. The Board believes that there are no pressing reasons to address this topic now. Although no specific standard addresses policyholder accounting comprehensively, some IFRSs address limited aspects of policyholder accounting. These include the paragraphs in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* that specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. Accordingly, the Board has not considered policyholder accounting, except for reinsurance contracts.

Product warranties (paragraph 4(a))

BC206 The exposure draft *Revenue from Contracts with Customers* identifies two categories of product warranties:

(a) warranties issued for short coverage periods to cover any defects that were undetected during the manufacture of the product. These warranties do not meet the definition of an insurance contract because they are intended to ensure that the seller satisfied the performance obligation, rather than to provide compensation for an uncertain future event.

(b) warranties that provide coverage for the customer for faults that arise after the product is transferred to the customer. These warranties meet the definition of an insurance contract and are often issued by an unrelated third party.

BC207 IFRS 4 regards all product warranties as insurance contracts, but excludes from its scope product warranties issued by a manufacturer, dealer or retailer. Under the draft IFRS, product warranties issued by a manufacturer, dealer or retailer would continue to be outside the scope of the IFRS on insurance contracts, either because they would now be analysed as not meeting the definition of an insurance contract (warranties against undetected defects) or because they would continue to be excluded from its scope (warranties providing coverage against subsequent faults).

Fixed-fee service contracts (paragraph 4(e))

BC208 A fixed-fee service contract is a contract in which the level of service depends on an uncertain event. Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. Such contracts meet the definition of an insurance contract because:

(a) it is uncertain whether, or when, a repair or assistance is needed;

(b) the owner is adversely affected by the occurrence; and

(c) the service provider compensates the owner if a repair or assistance is needed.

BC209 The Board proposes to exclude fixed-fee service contracts from the scope of the proposed IFRS if their primary purpose is the provision of services. In the Board's view, the existing practice of accounting for such contracts as revenue contracts provides relevant information for the users of financial statements for the entities that issue such contracts and changing the existing accounting for these contracts would impose costs and disruption for no significant benefit.

Identifying the insurance contract (unbundling) (paragraphs 8–11)

BC210 As discussed in paragraph BC14, insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows and cash outflows. In addition, paragraph BC15 explains that some insurance contracts provide more than just insurance coverage.

Insurance contracts can, for example, also provide the policyholder with goods or services other than insurance coverage (a revenue-generating transaction with a customer) or an investment (a financial instrument). Such components would, if accounted for as if they were separate contracts (unbundling), be within the scope of another IFRS. Goods or services other than insurance coverage would be accounted for under the revenue model and investment components would be accounted for under IFRS 9 or IAS 39.

BC211 The discussion paper proposed unbundling in some cases but not all, considering the extent to which interdependency would allow the insurer to measure a component separately. For conceptual and practical reasons, some respondents agreed with unbundling when it could be done in a way that is not arbitrary. Others opposed unbundling in all cases.

BC212 The Board identified the following benefits of unbundling an insurance contract:

(a) Transparency—unbundling can provide insight into the components of an insurance contract that do not respond to changes in circumstances in the same manner as components affected by insurance risk.

(b) Comparability—unbundling means that an insurer accounts in the same way for a non-insurance component as another entity with a separate, but otherwise identical, contract (eg a financial instrument issued by a bank or a fund manager). This would avoid sharp accounting discontinuities. Because unbundling would result in similar accounting for similar contracts, users of financial statements can better understand the risks undertaken by an entity, regardless of the type of business or industry in which the entity operates.

BC213 However, the Board also noted limitations of unbundling. Separating a single contract into components when the cash flows attributable to the components are intertwined could result in complex accounting. For example, it would require separating the intertwined cash flows, measuring them using a different measurement to comply with the accounting requirements, and tracking those separate cash flows throughout the life of the contract. Furthermore, in some cases an insurer may not be able to identify evidence to decide what to allocate to each of the components (in other words; separating the components goes beyond requiring the insurer's judgement and becomes arbitrary).

BC214 In developing the draft IFRS, the Board considered whether to require (or permit) unbundling, and, if so, which components should be unbundled. Requiring unbundling in all cases is unlikely to be appropriate because there are instances in which unbundling could diminish the usefulness of the financial statements if interdependent cash flows were arbitrarily split and measured on different bases. However, the Board concluded that in instances where a component is not closely related to the insurance coverage specified in the contract, unbundling that component would produce useful information at a reasonable cost.

BC215 An approach to unbundling that considers whether a component is closely related would provide a natural link with existing requirements for bifurcation. However, the Board's intention is not to require an exhaustive search for components in every insurance contract. Rather, the point of unbundling those components is to assist users in understanding the different facets of a hybrid contract, while achieving some degree of comparability between entities across industries.

BC216 To clarify its intention and assist insurers in applying the unbundling requirements, the Board identified the following most common examples of components that are not closely related to the insurance coverage:

(a) an investment component reflecting an account balance that meets criteria specified in paragraph 8(a) of the draft IFRS. As a result of those criteria, all charges and fees assessed against the account balance, as well as cross-subsidy effects included in the crediting rate, belong to either the insurance component or another component, but are not part of the investment component. Thus, the crediting rate applied to that account balance is determined after eliminating any cross-subsidy between that rate and the charges or fees assessed against the account balance. In that way, the investment component (account balance) would behave in a way similar to a stand-alone investment contract, without being affected by any cross-subsidy.

(b) an embedded derivative that is separated from its host contract in accordance with IAS 39. Paragraphs BC220–BC225 discuss embedded derivatives.

(c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

BC217 Other approaches to unbundling considered by the Board were based on:

(a) whether the component is so interdependent that the components cannot be measured separately on a basis that is not arbitrary (this was Board's preliminary view in the discussion paper).

(b) whether the component can introduce variability in the overall cash flows of the insurance contract for risks that are not considered part of the provision of insurance protection.

BC218 The Board rejected these approaches because of their potential lack of clarity; using either of those approaches would introduce a new bifurcation notion and might require extensive and detailed guidance.

BC219 The Board considered whether to permit unbundling when it is not required (ie when components are closely related). Some argue that, even though insurers are unlikely to opt for unbundling, they should be permitted to do so. Some insurers might find it easier to account for some components embedded in insurance contracts using the relevant guidance for similar stand-alone contracts. However, the Board concluded that permitting unbundling when it is not required would be inconsistent with the reasoning for not requiring it in the first place; it does not seem rational to permit something that would not be decision-useful. It could also undermine comparability.

Embedded derivatives (paragraph 12)

BC220 The Board identified an embedded derivative that is bifurcated under IAS 39 as a common example of a component that is not closely related to the insurance coverage. (Paragraphs BC76–BC82 discuss some of the embedded derivatives commonly found in insurance contracts.)

BC221 The existing bifurcation guidance in paragraphs AG30–AG33 of IAS 39 requires bifurcation of an embedded derivative if its economic characteristics and risks are not closely related to the host contract. More specifically, paragraph AG33(h) explains that an embedded derivative in an insurance contract is closely related to the economic characteristics and risks of the host insurance contract if that derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately, ie without considering the host contract.

BC222 The Board concluded that applying this existing bifurcation guidance would be internally consistent with the overall basis for unbundling, which also considers whether a component is closely related (see paragraph BC216). The Board did not address the bifurcation guidance in IAS 39 in its project on insurance contracts.

BC223 Some embedded derivatives meet the definition of an insurance contract. Those derivatives are not within the scope of IAS 39; an insurer applies IFRS 4 to such derivatives. The Board does not intend to change this; if an embedded derivative meets the definition of an insurance contract, that embedded derivative will be within the scope of the draft IFRS, and will not be bifurcated.

BC224 One example of an embedded derivative included in an insurance contract is a surrender option. Surrendering an insurance contract generally leads to cancellation of the entire contract (which would include any embedded derivatives and account balances). Therefore, a surrender option is often interdependent with various components of the contract and it may be difficult and burdensome to separate the effects of the surrender option. Applying paragraph AG33(h) of IAS 39, an insurer would determine whether that surrender option is closely related to the host insurance contract.

BC225 Paragraph 8 of IFRS 4 specifies that, as an exception to IAS 39, an insurer need not bifurcate a policyholder's option to surrender an insurance contract for a fixed amount, even if the exercise price differs from the carrying amount of the host insurance contract. Paragraph 9 of IFRS 4 provides the same exception for financial instruments that contain a discretionary participation feature. Because paragraph AG33(h) of IAS 39 already provides bifurcation guidance consistent with the proposed overall approach to unbundling, the draft IFRS does not carry forward this exception as a separate item. Instead, an insurer would apply the requirements in IAS 39 to determine whether it needs to bifurcate a surrender option.

Recognition (paragraphs 13–15) and derecognition (paragraphs 67 and 68)

BC226 The discussion paper proposed that an insurer should recognise an insurance contract when it becomes a party to the contract and the draft IFRS contains a similar proposal. This is consistent with the principle for recognising financial assets and financial liabilities in other IFRSs. Respondents to the discussion paper generally agreed with that proposal.

However, some respondents asked the Board to clarify how to account for insurance contracts entered into a significant time (eg a few months) before the start of the coverage period. They questioned whether insurers should instead treat such contracts before the start of the coverage period as derivatives or as fully executory. However, the Board concluded that:

(a) no benefit would arise for users if an insurer were to account separately for an insurance contract as a derivative (an option or forward) before the start of the coverage period. A derivative contract to provide insurance in the future would meet the definition of an insurance contract and be measured in the same way as the underlying insurance contract. Therefore, accounting for an insurance contract as a derivative before it starts would add complexity without providing any improved information for users.

(b) an insurer should not treat an insurance contract in the same way as an executory contract before the start of the coverage period. Typically, entities do not recognise assets and liabilities as a result of executory contracts. Although in most cases there would be no significant assets and liabilities between signing the contract and the start of the coverage period, recognising the contract in the financial statements at the date it is signed would require the insurer to account for changes in circumstances that make the contract onerous.

BC227 The draft IFRS proposes that an insurance contract liability should be derecognised when it has been extinguished. This proposal is consistent with the proposal in the discussion paper that insurance liabilities should be derecognised on the same basis as financial liabilities, is consistent with the requirement in IFRS 4 and provides symmetrical treatment for the recognition and derecognition of insurance contracts.

BC228 Some respondents to the discussion paper said that an insurer might not know precisely whether a liability has been extinguished because claims are sometimes reported many years after the end of the coverage period. Those respondents were concerned that an insurer might be unable to derecognise those contracts, which in some cases might result in accounting that is unreasonable and unduly burdensome. However, in the Board's view, it would not be a faithful representation of an insurer's financial position to ignore contractual obligations that remain in existence and can generate valid claims. Also, an insurer would not measure the liability at a material amount if it has no information that a possible claim exists. Accordingly, there may be little practical difference between recognising an insurance liability measured at an immaterial amount and derecognising the liability.

BC229 Because derecognition of financial assets is a complex topic and the subject of another project, the draft IFRS does not address derecognition of insurance assets.

Reinsurance (paragraphs 43–46)

BC230 This section deals with reinsurance liabilities of a reinsurer and reinsurance assets of a cedant (ie the insurer holding a reinsurance contract).

Reinsurance liabilities of a reinsurer

BC231 The Board has identified no reason to apply different requirements to direct insurance liabilities and reinsurance liabilities. Therefore, the draft IFRS proposes that a reinsurer should use for the reinsurance contracts that it issues the same recognition and measurement approach as all insurers use for the other insurance contracts that they have issued.

Reinsurance assets of a cedant (paragraphs 43–46)

BC232 The draft IFRS carries forward the following requirements of IFRS 4, because the Board is aware of no reason to change them:

(a) An insurer does not derecognise insurance liabilities until the contractual obligations are extinguished (by discharge, cancellation or expiry). It follows that a cedant typically would not derecognise the related direct insurance liabilities upon entering into a reinsurance contract.

(b) A cedant does not offset reinsurance assets against related insurance liabilities, and does not offset reinsurance income and expense against related insurance expense and income.

BC233 The draft IFRS proposes that a cedant should measure its reinsurance assets on the same basis as its underlying direct insurance liability. The following paragraphs discuss two aspects of reinsurance assets:

(a) margins (paragraphs BC234–BC237).

(b) impairment (paragraphs BC238–BC241).

Margins

BC234 The amount paid for reinsurance by a cedant comprises premiums paid by the cedant, less ceding commissions paid by the reinsurer, and can be viewed as payment for the following:

(a) the reinsurer's share of the expected present value of the cash flows generated by the underlying direct insurance contract(s).

(b) a risk adjustment for the risk associated with the underlying direct insurance contract(s). For those underlying contracts, the risk adjustment increases the measurement of the cedant's liability. In contrast, the risk adjustment increases the measurement of the cedant's reinsurance asset. This is because the reinsurance asset reduces risk for the cedant. The greater the risk arising from the underlying insurance contracts, the greater the value to the cedant of its reinsurance asset.

(c) an adjustment for the risk of non-performance by the reinsurer (ie the risk that the reinsurer may dispute coverage or fail to satisfy its obligations under the reinsurance contract).

(d) a residual margin that makes the initial measurement of the reinsurance asset equal to the premium paid at inception. This margin may differ from the residual margin arising for the underlying direct insurance contract(s).

BC235 Although both the cedant and reinsurer would measure their contractual rights and obligations on the same basis, in practice they would not necessarily arrive at the same amount (ie there is no 'mirror accounting'). This may be because the estimates are based on access to different information and different experiences as well as differences in the composition of their portfolios, for example by including different adjustments for diversification effects.

BC236 The amount paid by the cedant would typically exceed the expected present value of cash flows generated by the reinsurance contracts plus the risk adjustment. Thus, a positive residual margin would typically arise at the initial recognition of a reinsurance contract. The Board considered whether the residual margin in the reinsurance contract could be negative if, in rare cases, the amount paid by the cedant is less than the expected present value of cash flows plus the risk adjustment. The Board noted that the most likely causes of such a negative difference would be:

(a) an overstatement of the underlying direct insurance contract(s). A cedant would deal with this by reviewing the measurement of the direct contract(s).

(b) favourable pricing by the reinsurer, for example as a result of diversification benefits. The Board concluded that the recognition of a gain would be appropriate in such cases. This is because doing so is consistent with the Board's conclusion that the residual margin for the underlying contract should not be negative (although for the underlying contract the consequence is the immediate recognition of a loss, rather than the immediate recognition of a gain).

BC237 National accounting requirements have often tried to address a concern that profit or loss might be distorted by the timing of the decision to buy reinsurance. Such distortions are a particular concern if contracts have the legal form of reinsurance but do not transfer significant insurance risk (sometimes known as financial reinsurance). Such distortions arise because of inadequacies in some existing measurement approaches for the underlying insurance liabilities, for example, the use of an undiscounted measurement basis for many non-life insurance claims liabilities. By eliminating those inadequacies in the measurement of the underlying contract(s), the proposals in the draft IFRS would significantly reduce the need for restrictions on the recognition of misleading gains at initial recognition of reinsurance contracts.

Impairment

BC238 A cedant faces the risk that the reinsurer may default, or may dispute whether a valid claim exists for an insured event. There are two possible approaches to account for this risk:

(a) incurred loss model: losses should be recognised only when an event, occurring after initial recognition of an asset, provides objective evidence that the asset is impaired.

(b) expected loss model: losses should be recognised for expected (probability-weighted) losses from default or disputes.

BC239 IAS 39 determines the impairment of financial assets by applying an incurred loss model. Proponents of an incurred loss model believe that it provides more objectivity than an expected loss model. In developing IFRS 4, the Board adopted an incurred loss model for reinsurance assets because its aim was to achieve consistency with IAS 39 in a context where many reinsurance assets were not measured at a current value.

BC240 However, because the proposed measurement model uses an expected value approach for the underlying cash flows, the Board now proposes to require an expected loss model for reinsurance assets. In other words, the current exit value of the reinsurance asset would incorporate a reduction for the expected (probability-weighted) present value of losses from default or disputes. This is consistent with a measurement model that starts with the expected present value of cash flows. Furthermore, this approach is consistent with the Board's exposure draft *Financial Instruments: Amortised Cost and Impairment*, which proposes to switch to an expected loss model for financial assets.

BC241 The proposed expected loss model does not include a further reduction in the carrying amount of the reinsurance asset to reflect the risk that losses from defaults or disputes may ultimately exceed their expected value (in addition to the reduction for expected losses). Such a risk adjustment might be conceptually consistent with the risk adjustment proposed in the draft IFRS, but in the Board's view it would introduce excessive complexity for little or no benefit to users of a cedant's financial statements.

Disclosure (paragraphs 79–97)

BC242 The Board proposes as an objective that an insurer should disclose information to help users of financial statements understand the amount, timing and uncertainty of future cash flows, supplemented with some specific disclosures intended to help the insurer satisfy that principle. By specifying an objective, the Board eliminates the need for detailed and prescriptive disclosure requirements to meet the specific information needs for the various types of insurance contract. However, in situations when the information provided in accordance with the specific disclosures is not sufficient to meet that objective, the draft IFRS would require the insurer to disclose whatever additional information is necessary to meet that objective.

BC243 The Board used the disclosure requirements in IFRS 4 (including the disclosure requirements in IFRS 7 that are incorporated in IFRS 4 by cross-reference) as a basis for its proposals. In addition, the Board proposes to include the following items in the draft IFRS:

(a) a principle on the level of aggregation (see paragraph 79). This is consistent with other current proposals by the Board and would require an insurer to choose the most useful disaggregation level to satisfy the disclosure principle.

(b) information about the amounts recognised:

(i) a more detailed reconciliation of changes in the contract balances, including disclosures about changes in the risk adjustment, which is a key component of the measurement model (see paragraph 85).

(ii) a more detailed explanation of methods, inputs and processes used in the measurement. Because the proposed measurement for insurance contracts is a current measure of items that may be difficult to measure, the transparency of the inputs and methods used is important to users of the financial statements (see paragraph 90(a)).

(iii) a translation of risk adjustments into a confidence level for disclosure, even if the insurer had not used that technique to determine the risk adjustment (ie if the insurer used a conditional tail expectation or a cost of capital technique). That disclosure would enhance comparability among insurers (see paragraphs 90(b), BC116 and BC117).

(iv) a measurement uncertainty analysis. This would inform users about the extent to which the insurer might reasonably have arrived at different measurements (see paragraph 90(d)).

(c) information about the nature and extent of risks arising from insurance contracts: the effect of the regulatory framework in which the insurer operates. The Board recently proposed a similar requirement for post-employment benefits in the exposure draft *Defined Benefit Plans* (see paragraph 92).

Transition (paragraphs 98–102)

BC244 This section discusses:

(a) determination of the residual margin on transition (paragraphs BC245–BC249).

(b) elimination of deferred acquisition costs and some other intangibles (paragraph BC250).

(c) disclosure of claims development (paragraph BC251).

(d) first-time adopters of IFRSs (paragraph BC252).

(e) redesignation of financial assets (paragraph BC253).

Transition for a residual margin (paragraph 100(a))

BC245 As already noted, the proposed measurement model comprises two elements:

(a) a direct measurement, based on estimates of future cash flows and an explicit risk adjustment; and

(b) a residual margin, determined at initial recognition of the insurance contract and then released over the coverage period.

BC246 The Board has identified no specific transitional problems for the introduction of the direct measurement component of the measurement. That measurement is current and reflects circumstances at the measurement date. Therefore, provided an insurer has sufficient lead time to set up the necessary systems, performing that direct measurement on transition to the new model will be no more difficult than performing that measurement for a later date.

BC247 Determining the remaining amount of the residual margin on transition to the new model may be more problematic. In principle, the insurer would need to estimate the future cash flows as it would have estimated them at initial recognition of the contracts. That exercise may be burdensome and costly and is subject to bias through the use of hindsight.

BC248 IAS 8 *Accounting Policies, Changes in Estimates and Errors* prohibits the retrospective application of an accounting policy to the extent that this would be impracticable, as defined in IAS 8. The Board concluded that retrospective determination of the residual margin would sometimes be impracticable in that sense and, if not impracticable, it would often cause costs disproportionate to the resulting benefit for users. Accordingly, the exposure draft proposes that an insurer should, on first applying the new IFRS, measure its existing contracts at that date by setting the residual margin equal to zero. In consequence, for contracts in force when the new IFRS comes into effect, an insurer will not recognise residual margins as income for any subsequent period. However, the insurer will recognise income arising from the release of residual margins for contracts recognised initially after adopting the IFRS.

BC249 The Board also considered another approach that would have determined the residual margin on transition to the new IFRS as the difference (but not less than zero) between (a) the carrying amount of the insurance liability immediately before transition and (b) the present value of the fulfilment cash flows at that date. That approach would have had the

advantage of maintaining some continuity with previously reported profit or loss, without imposing significant additional costs. However, the Board rejected that approach because the resulting residual margins would not have been comparable with residual margins for subsequent contracts and would have depended significantly on the pattern of income recognition under previous accounting models, which are not uniform.

Elimination of deferred acquisition costs and some other intangibles (paragraph 100(b) and (c))

BC250 When an insurer applies the new measurement model, it would need not only to adjust the measurement of its insurance contracts, but also to eliminate some related items, if any, such as deferred acquisition costs and some intangible assets relating solely to existing contracts. Those items could be viewed as corrections for a previous overstatement of the insurance liability, and so their elimination is likely to coincide with a reduction in the measurement of the insurance liability.

Disclosure of claims development (paragraph 101)

BC251 Paragraph 44 of IFRS 4 exempts an insurer from disclosing some information about claims development in prior periods. The Board proposes to carry forward a similar exemption, for cost-benefit reasons.

First-time adopters of IFRSs (paragraph 98)

BC252 The proposed transition requirements would apply both to first-time adopters of IFRSs and to insurers that already apply IFRSs. The Board sees no reason to treat first-time adopters differently in this respect.

Redesignation of financial assets (paragraph 102)

BC253 On transition to IFRS 4, the Board permitted an insurer to redesignate its financial assets as available for sale to avoid an accounting mismatch that arises when the insurer's financial assets are measured at fair value and its insurance liabilities are measured on a cost basis (which IFRS 4 allows). The Board understands that insurers applying IFRS 9 (which removes the available for sale classification) before the new IFRS on insurance contracts may wish to reclassify some of their financial assets, where allowed, at amortised cost rather than at fair value through profit or loss in order to continue to avoid the accounting mismatch. However, because the draft IFRS would measure insurance liabilities at a current value with all

remeasurements recognised in profit or loss, accounting mismatches would arise if an insurer continues to measure its financial assets at amortised cost. To avoid that outcome, the Board proposes that on adoption of the draft IFRS an insurer would be permitted to use the fair value option to redesignate its financial assets by measuring them at fair value through profit or loss (see paragraph 100).

Effective date and early adoption (paragraph 99)

BC254 The Board will consider collectively the effective dates and transition for the IFRSs—including insurance contracts—that it has targeted to issue in 2011 and, as part of that consideration, will publish, in conjunction with the FASB, a separate consultation paper to seek comments from interested parties. Hence, the Board may modify its previously stated preferences in the case of some individual IFRSs.

BC255 Consequently, the proposed requirements do not specify a possible effective date or whether the proposed requirements could be adopted early, but the Board intends to provide enough time to implement the proposed changes.

BC256 As part of that consideration, the Board will also consider whether to permit early adoption of those IFRSs. However, because IFRS 4 permits an insurer to change accounting policies for insurance contracts if the insurer shows that the change results in more relevant or reliable information, it is unlikely to be feasible for the IASB to prohibit early adoption of the IFRS on insurance contracts.

BC257 As noted in the Basis for Conclusions on IFRS 9 *Financial Instruments,* issued in November 2009, the Board will consider delaying the effective date of IFRS 9 if the new IFRS on insurance contracts has a mandatory effective date later than 2013, so that an insurer would not have to face two rounds of major changes in a short period.

Benefits and costs

BC258 The objective of financial statements is to provide information about an entity's financial position, financial performance and cash flows that is useful to a wide range of users in making economic decisions. To attain that objective, the Board tries to ensure that a proposed standard will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Existing investors primarily bear the costs of implementing a new standard. Although those costs

might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital, including credit, and the efficient allocation of resources in the economy.

BC259 The evaluation of costs and benefits is necessarily subjective. In making that judgement, the Board considers the following:

(a) the costs incurred by preparers of financial statements;

(b) the costs incurred by users of financial statements when information is not available;

(c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information; and

(d) the benefit of better economic decision-making as a result of improved financial reporting.

BC260 The Board thinks that the proposed IFRS would improve financial reporting by insurers because it would recognise, measure and present life and non-life insurance contracts and direct insurance and reinsurance contracts on a consistent and comparable basis (with some modifications for the pre-claims period for particular short-duration contracts. The new approach should also improve the understandability of an insurer's financial statements. In contrast, because a range of insurance accounting practices can be applied under IFRS 4 (as paragraph BC5 explains), users of an insurer's financial statements may be unable to compare those financial statements with those of another insurer that writes the same insurance business. Furthermore, under IFRS 4, an insurer's financial statements could include internal inconsistencies if different recognition, measurement or presentation principles are applied to different types of insurance contracts.

BC261 The Board believes that the building blocks approach, including the separate identification of a risk adjustment, would result in a more faithful representation of an insurance contract. Because the measurement basis is a current measurement, the proposed IFRS also resolves many of the accounting mismatches that can arise at present in an insurer's financial statements. The mismatch arises when an insurer's assets are measured at a current value amount (ie fair value) but its corresponding insurance contract liabilities are not.

BC262 Some insurers might need to make systems and operational changes to comply with the requirements in the proposed IFRS. The Board thinks that the costs involved to make systems changes to collect the information required by the proposed IFRS will be incurred primarily during the transition from IFRS 4. Depending on the internal processes that an insurer uses in managing its insurance businesses, the insurer may incur additional costs on an ongoing basis to change operational processes as well. For instance, some insurers do not regularly make an explicit estimate of the future cash flows required to fulfil an insurance contract. Similarly, determining risk adjustments is an emerging practice in the insurance industry, and so only some insurers have developed the processes and systems to do this. Although an insurer will incur costs to establish and maintain the systems and processes necessary to make explicit cash flow estimates and to manage risk adjustments, the Board thinks that this will result in the provision to users of better information about an insurer's insurance contracts and it might also improve the quality of the information that internal managers use in managing their businesses.

BC263 On balance, the Board concluded that the proposed IFRS would improve the financial reporting of insurance contracts at a reasonable cost. In developing the proposed IFRS, the Board concluded that, for some short-duration insurance contracts, the cost of applying some aspects of the proposed IFRS might exceed the benefits. Consequently, for those contracts, the Board decided to require the use of the amount of unearned premium (calculated in accordance with paragraph 56) to simplify the measurement of the pre-claims liability. As paragraph BC146 explains, the Board determined that the unearned premium would be a reasonable approximation of the present value of fulfilment cash flows and the residual margin.

Appendix

Differences between the proposals in the exposure draft and the FASB's approach

In developing the exposure draft, most of the Board's discussions on the insurance contracts model were held jointly with the FASB and many of the decisions on the features of the model were made jointly with the FASB. However, some differences remain.

The main differences between the IASB and FASB models relate to:

(a) Measurement—in the FASB model, risk and uncertainty are reflected implicitly through a single composite margin rather than explicitly through a separate risk adjustment. No measurement differences arise at initial recognition of the insurance contract because both the IASB and FASB models calibrate the residual margin and composite margin (respectively) to the consideration received or receivable from the policyholder. However, differences arise after initial recognition because in the FASB model:

   (i) the composite margin would not be remeasured to reflect any increases in risk and uncertainty or to reflect any changes in the price for bearing risk and uncertainty.

   (ii) the composite margin would be amortised over the coverage period and claims handling period according to the following formula, which is intended to approximate the pattern of the decline of risk that the insurer is subject to under the contract.

      (Premium allocated to current period + current period claims and benefits)/(Total contract premium + Total claims and benefits)

   (iii) interest is not accreted on the composite margin on the grounds of simplicity and because the FASB views the margin as a deferred credit rather than as a representation of a component of an obligation.

(b) Scope—the FASB has tentatively decided not to include participating investment contracts within the scope of a new insurance contracts standard because it believes the arguments for treating them in the same way as insurance contracts in paragraph BC199 are insufficient to justify excluding these contracts from the scope of its financial instruments standards.

The following table summarises the similarities and differences between a composite margin and a risk adjustment plus a residual margin.

	IASB: Risk adjustment plus residual margin	**FASB: Composite (single) margin**
Gain possible at inception?	No	No
Loss possible at inception	Yes	Yes (but less likely, see paragraph BC115)
Risk adjustment included in determining whether a loss arises at inception, and measuring any such loss?	Yes	No
Explicit remeasurement for risk each period?	Yes	No
Does risk adjustment decline over time?	Generally, yes, but could increase, for example if a new uncertainty emerges.	N/A
Can risk adjustment increase after initial recognition?	Yes, but this is likely to be rare in practice.	N/A
Can residual or composite margin increase after initial recognition?	No	No
How is the risk adjustment released to income over time?	Explicit measurement, reflecting reduction in remaining risk.	N/A

How is residual or composite margin released to income over time?	Over the coverage period on the basis of passage of time or, if significantly different, on the basis of the pattern of claims and benefits, as expected at inception.	On the basis of reduction in exposure from both: • the provision of insurance coverage over the coverage period, and • uncertainties related to future cash flows during the claims handling period (for life contracts usually similar to the coverage period).
Is release from risk one possible driver of the residual margin or composite margin?	No. The risk adjustment accounts for risk.	Yes
What margin is included on transition?	The risk adjustment only. The residual margin would be set at zero.	The composite margin would be set equal to the risk adjustment determined in the other approach. That adjustment would not be remeasured subsequently, it would simply be released to income in the same way as any other composite margin. This is the only purpose for which a risk adjustment would be used in the composite margin approach.

Alternative views of Jan Engström and John T Smith

AV1 Mr Engström and Mr Smith voted against publication of this exposure draft, *Insurance Contracts*, because they disagree with many of the provisions in the proposed Standard used to determine the insurance liability and to recognise changes in that liability. They believe the proposal will produce inappropriate results. They believe the proposal will impede comparability because it provides an unacceptably wide variation in determining insurance liabilities and considerable latitude to manage earnings. Mr Engström and Mr Smith further find the proposed presentation inadequate to users' needs and unsuitable for companies where insurance is not the main activity.

AV2 Mr Engström and Mr Smith disagree with the dual-margin approach specified in this exposure draft. They believe it complicates results, impedes comparability and adds another layer of subjectivity to the already highly subjective estimates of future cash inflows and outflows that can span a term of fifty plus years. They believe it is not possible to objectively compute a risk adjustment or to expect any kind of comparability from an estimate representing the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. The exposure draft identifies methods for estimating the risk adjustment. However, the risk adjustment is based on each insurer's own tolerance and price for risk thereby providing considerable latitude in deciding what level of risk should be included in the risk adjustment and what price would be charged for that level of risk. Mr Engström and Mr Smith believe that without a reference to actual transactions, the risk adjustment is not the price of risk but rather a hypothetical amount that is selected arbitrarily by each insurer choosing a level and price at that level based on its own perceptions of risk. Under the proposed approach, the risk adjustment and its complement, the residual margin, can vary significantly by insurer for the same risk thereby producing significantly different results in financial statements. Indeed, at one end of the spectrum an insurer could set the quantity and price of risk to eliminate any residual margin.

AV3 Mr Engström and Mr Smith disagree with the provision in the exposure draft that the residual margin be locked in at inception for all types of changes in the estimate of the insurance liability. They believe some changes in estimates are not primarily related to changes in insurance risk and that the resulting changes in the insurance liability should be recognised as an adjustment of the residual margin and, accordingly, recognised in profit or loss over time.

AV4 Mr Engström and Mr Smith also are concerned that the interplay between the risk adjustment and residual margin will impede comparability. For example, if two insurers have insurance contracts with similar risks but arrive at different risk adjustments at inception and in the immediate subsequent period one of them changes its estimate and now arrives at the same risk adjustment as the other, their period to period results will never be the same because the change in the risk adjustment is recognised directly in profit or loss and the residual margins being locked in at inception will never be aligned.

AV5 While Mr Smith disagrees with the dual margin approach, he believes some of its disadvantages could be mitigated if changes in the risk adjustment resulting from changes in the level of risk and price of risk selected by the insurer are recognised as an adjustment of the residual margin and changes in the risk adjustment arising from changes in the risk profile of the cash flows are recognised in profit or loss.

AV6 Mr Engström and Mr Smith disagree with the provision in the exposure draft that requires any change in expectations of customers exercising options to renew insurance contracts to be recognised in profit or loss. They believe the change should be recognised as an adjustment of the residual margin. Mr Engström and Mr Smith believe that the benefit from expectations of customers exercising options to renew insurance contracts is an intangible asset that would fail current recognition requirements. They accept the inclusion of this benefit from expectations of customer behaviour in the initial measurement of the insurance contract because no gain is recognised at inception. Any net benefit from expectations of customer renewals is included in the margin.

AV7 Mr Smith believes that, economically, part of the insurance premium charged at inception is a charge for the renewal option written by the insurer and conceptually it should be separated from the contract and recognised and measured as a written option. If recorded separately, it would be priced as an option and accounted for as a liability until it was exercised or expired. Accordingly, Mr Smith believes that any net benefit from a change in expectations of customers renewing insurance contracts should not offset the insurance liability or be recognised currently. He believes it should be an adjustment of the residual margin. Mr Smith is concerned that the proposal in the exposure draft will promote structuring opportunities for changing estimates of customer renewals. Mr Smith also is concerned about the lack of comparability as in the situation in which two insurers having insurance contracts with similar risks arrive at different expectations of customer renewals at

inception. If in the immediate subsequent period one of them changes its estimate and now arrives at the same expectation of renewals as the other, their period to period results will never be the same because the adjustment is recognised directly in profit or loss and the residual margins being locked in at inception will never be aligned.

AV8 Mr Smith disagrees with the requirement in the exposure draft to recognise participation features as a part of the insurance liability. Mr Smith believes that these features do not meet the definition of a liability under the *Framework* because the insurer has discretion over the amount or timing of the payment. He believes the recognition of these features provides a basis for managing earnings because they are intent driven and he does not understand what is so unique about an insurance contract to permit recognition of an amount based on intent. Accordingly, he also disagrees that any changes in intent about the amount the insurer will pay in the future should be recognised directly in profit or loss. Mr Smith believes there is no insurance risk associated with these features. They effectively permit the insurer to reprice the insurance contract and relate more to the pricing of the insurance product, the premium being charged. Mr Smith understands there is a relationship between the amounts of participation paid and level customer renewals. Accordingly, Mr Smith would require that any change in intent about future payments relating to these features be recognised as an adjustment of the residual margin consistent with his recommendation for the recognition of changes in customer renewals as described above.

AV9 Mr Smith disagrees with the requirement in the exposure draft for unbundling non-insurance components based on whether those components are closely related to the insurance coverage specified in the contract. Whether a component is closely related to insurance is not defined except for derivatives based on the IFRS 4 amendment to IAS 39 that specifies that an embedded derivative and the host insurance contract are closely related if they are so interdependent that the entity cannot measure the embedded derivative separately. Because closely related is based on interdependence as specified in IAS 39, Mr Smith believes that concept will be applied in all situations where there is no explicit guidance. Mr Smith is concerned about the application of that approach because the Board and the FASB struggled with the concept of interdependence and rejected it because they were unable to decide how to make it operational. Mr Smith disagrees with the application of this concept because it is not operational and in particular for derivatives because it is not applied in any other situation in which a derivative is embedded in a host contract. He does not understand what is so unique

about an insurance contract to be exempted on a basis of interdependence. Mr Smith believes this approach will create structuring opportunities to avoid recognition of derivatives at fair value by embedding them into insurance contracts. In addition, Mr Smith would require a contract that permits a policyholder to obtain a derivative-based cash settlement in lieu of maintaining insurance, to be measured and accounted for at fair value.

AV10 Mr Smith disagrees with the requirement in the exposure draft to treat financial instruments with discretionary participation features as insurance contracts because they do not contain any insurance risk. As stated above he also disagrees with recognising discretionary participation features as liabilities because they don't meet the definition of a liability under the Framework. He does not understand what is so unique about a financial instrument with a participation feature to require recognition of that instrument as an insurance liability. He believes this requirement permits structuring to avoid recognition of financial instruments under the accounting standards for financial instruments. He believes the intent-based nature of the participation feature and the subjectivity in applying a risk adjustment to estimates of cash flows under this exposure draft will create an accounting arbitrage inviting deposit taking institutions or any entity to add a participation feature to a financial liability to account for that instrument under this proposed standard. Having added a participation feature to the liability, the entity could avoid separating out embedded derivatives, then add a few renewal options, estimate cash flows considering its own tolerance and price for risk at inception and then subsequently change its intent about the extent of participation payments and immediately recognise the change in profit or loss.

AV11 Mr Engström and Mr Smith are concerned the exposure draft defines insurance contracts too broadly. Mr Smith disagrees with the requirement in paragraph B33 that specifies that a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished. He would exclude from the definition those contracts in which the insurance component has expired. He believes that any remaining obligation is a financial instrument that should be accounted for under IAS 39 or IFRS 9. He also would exclude from the definition of an insurance contract those contracts that are regarded as transferring significant insurance risk at inception only because they include a pricing option permitting the holder to purchase insurance at a specified price at a later date.

AV12 Given all of the concerns specified above, Mr Engström and Mr Smith believe the scope of this standard should be narrow and they would apply it only to life and health insurance contracts. For other insurance contracts they would favour the use of a method similar to the modified method for short-term contracts described in paragraphs 55–60.

AV13 Insurance can be described as being paid to assume risk, reimburse insurance claims, have some internal expenses and possibly earn a financial return between the payments of premiums and claims. Presentation should, in Mr Engström's and Mr Smith's opinion, follow that structure and should, regardless of performance measurement model, allow focus on revenue earned from paid premiums and actual insurance claims costs.

