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Illustrative Examples

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Insurance Contracts

Comments to be received by 25 October 2013

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Illustrative Examples on Exposure Draft Insurance Contracts

Comments to be received by 25 October 2013

These Illustrative Examples accompany the Exposure Draft ED/2013/7 *Insurance Contracts* (issued June 2013; see separate booklet). The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by **25 October 2013** and should be submitted in writing to the address below or electronically via our website www.ifrs.org using the 'Comment on a proposal' page.

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INTRODUCTION IE1

SEPARATING COMPONENTS FROM AN INSURANCE CONTRACT IE3

Example 1—separating components from a life insurance contract with account balance

Example 2—separating components from a whole-life contract

Example 3—separating components from a stop-loss contract with claims processing services

MEASUREMENT ON INITIAL RECOGNITION OF AN INSURANCE CONTRACT THAT THE ENTITY ISSUES IE4

Example 4—measurement on initial recognition of an insurance contract that the entity issues

MEASUREMENT ON INITIAL RECOGNITION OF A REINSURANCE CONTRACT HELD IE8

Example 5—measurement on initial recognition of a reinsurance contract held

SUBSEQUENT MEASUREMENT OF AN INSURANCE CONTRACT THAT THE ENTITY ISSUES IE9

Example 6—subsequent measurement of insurance contracts that the entity issues

PRESENTATION OF INSURANCE CONTRACT REVENUE AND EXPENSES IE12

Example 7—presentation of insurance contract revenue and expenses in the statement of profit or loss and other comprehensive income

SUBSEQUENT RECOGNITION OF DIRECTLY ATTRIBUTABLE ACQUISITION COSTS IE16

Example 8—subsequent recognition of directly attributable acquisition costs

MEASUREMENT OF INSURANCE CONTRACTS THAT WERE ACQUIRED IN A PORTFOLIO TRANSFER IE19

Example 9—measurement of a portfolio of insurance contracts that were acquired in a portfolio transfer

MEASUREMENT OF INSURANCE CONTRACTS THAT WERE ACQUIRED IN A BUSINESS COMBINATION IE21

Example 10—measurement of insurance contracts that were acquired in a business combination

MEASUREMENT AND PRESENTATION FOR CONTRACTS THAT REQUIRE THE ENTITY TO HOLD UNDERLYING ITEMS AND SPECIFY A LINK TO RETURNS ON THOSE UNDERLYING ITEMS IE23

Example 11—contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

RECOGNITION AND DERECOGNITION OF BALANCES ON TRANSITION IE26

Example 12—recognition and derecognition of balances of transition

MEASUREMENT OF INSURANCE CONTRACTS ON TRANSITION IE28

Example 13—measurement of insurance contracts on transition

[Draft] International Financial Reporting Standard X *Insurance Contracts* Illustrative Examples

These examples accompany, but are not part of, the [draft] Standard. They illustrate aspects of the [draft] Standard but are not intended to provide interpretative guidance.

Introduction

IE1 The following examples are intended to illustrate how an entity might apply the requirements of the [draft] Standard to particular aspects of the accounting for insurance contracts on the basis of the limited facts provided in the examples. Additional factors would most likely be required to fully evaluate how to apply those requirements. The evaluations following each example are not intended to represent the only manner in which the [draft] Standard could be applied.

IE2 The examples address specific issues in the [draft] Standard and Application Guidance:

(a) separating components from an insurance contract (see paragraph IE3);

(b) measurement on initial recognition of an insurance contract that the entity issues (see paragraphs IE4–IE7);

(c) measurement on initial recognition of a reinsurance contract held (see paragraph IE8);

(d) subsequent measurement of an insurance contract that the entity issues (see paragraphs IE9–IE11);

(e) presentation of insurance contract revenue and expenses (see paragraphs IE12–IE15);

(f) subsequent recognition of directly attributable acquisition costs (see paragraphs IE16–IE18);

(g) measurement of insurance contracts that were acquired in a portfolio transfer (see paragraphs IE19–IE20);

(h) measurement of insurance contracts that were acquired in a business combination (see paragraphs IE21–IE22);

(i) measurement and presentation for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (see paragraphs IE23–IE25);

(j) recognition and derecognition of balances on transition (see paragraphs IE26–IE27); and

(k) measurement of insurance contracts on transition (see paragraphs IE28–IE29).

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Separating components from an insurance contract (paragraphs 9–11 and B31–B35)

IE3 Paragraphs 10 and B31–B35 specify the requirements for separating non-insurance components from insurance contracts. The following examples illustrate how those requirements apply to some contracts.

Example 1: separating components from a life insurance contract with account balance

Fact pattern

An entity issues a life insurance contract with an account balance. The policyholder pays a premium of CU1,000 at contract inception. The account balance is increased annually by voluntary amounts paid by the policyholder, increased or decreased by amounts calculated using the returns from specified assets and decreased by fees that comprise:

(a) asset management fees at an annual rate of 1.5 per cent of the account balance; and

(b) an insurance charge at an annual rate of CU125, determined as 2.5 per cent of the death benefit of CU5,000.

The contract promises to pay the following:

(a) the death benefit of CU5,000 and the amount equal to the account balance, if the policyholder dies.

(b) an amount that is equal to the account balance, if the contract is cancelled by the policyholder (ie there are no surrender charges).

An investment product that is equivalent to the account balance but without the insurance coverage is sold by another financial institution.

The entity considers whether to separate the asset management services or the account balance.

Separating the asset management services

In this contract:

(a) the policyholder can benefit separately from providing the asset management services and the insurance coverage by (i) receiving returns from the specified assets (the entity's performance obligation to provide asset management services) and by (ii) receiving a death benefit from the insurance component; and

(b) the risk and value of the death benefit does not depend on the amounts that are accumulated in the account balance.

Consequently, the asset management services are distinct (see paragraphs B33–B35) and would be separated from the insurance contract and accounted for by applying [draft] IFRS X *Revenue from Contracts with Customers*.[(a)]

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Example 1: separating components from a life insurance contract with account balance

Separating the account balance

The existence of a comparable investment product indicates that the components may be distinct (see paragraph B31). However, the right to death benefits provided by the insurance cover either lapses or matures at the same time as the account balance, which means that the insurance and investment components are highly interrelated and are therefore not distinct (see paragraph B32). Consequently, the account balance would not be separated from the insurance contract and would be accounted for by applying this [draft] Standard.

(a) The IASB plans to update the requirements in these proposals to be consistent with [draft] IFRS X *Revenue from Contracts with Customers* when it finalises the [draft] Standard on insurance contracts, where necessary.

Example 2: separating components from a whole-life contract

Fact pattern

An entity issues a traditional whole-life contract that promises to pay a death benefit of CU5,000 whenever the policyholder dies, for a premium of CU1,000. The contract allows the policyholder to cancel the contract before death and receive an amount (ie a cash surrender value) that initially equals CU100 and increases by 10 per cent per annum. The entity has a claims processing department to process the claims received and an asset management department to manage its investments.

The entity considers whether the claims processing services, the asset management services or the cash surrender value should be separated from the insurance contract.

Separating the claims processing services and asset management services

The claims processing and asset management services are part of the activities that the entity must undertake to fulfil the contract, and the entity cannot transfer a good or service to the policyholder as those activities occur. Consequently, in accordance with paragraph B33, those services are not performance obligations and should not be separated from the insurance contract. Consequently, both would be accounted for applying this [draft] Standard.

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Example 2: separating components from a whole-life contract

Separating the cash surrender value

The contract promises either CU5,000 when the policyholder dies or the cash surrender value if the policyholder surrenders the policy before death. Accordingly, the value of the death benefit is the difference between CU5,000 and the accumulated cash surrender value. In addition, both the insurance component and the investment component lapse together. Consequently, in accordance with paragraph B32, the investment component is highly interrelated with the insurance component and is not distinct. The investment component would therefore not be separated from the insurance contract and would be accounted for applying this [draft] Standard.

Example 3: separating components from a stop-loss contract with claims processing services

Fact pattern

An entity issues a stop-loss contract to an employer (the policyholder). The contract provides health coverage to the employer's employees and has the following features:

(a) 100 per cent insurance coverage for aggregate claims from employees exceeding CU25 million (the 'stop-loss threshold'). The employer will self-insure claims from employees up to CU25 million.

(b) claims processing services to process the employees' claims for the next 12 months, regardless of whether the claims have passed the stop-loss threshold of CU25 million. The entity is responsible for processing the health insurance claims of the employees on behalf of the employer.

The entity considers whether to separate the claims processing services. The entity noted that similar services to process claims on behalf of customers are sold on the market.

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Example 3: separating components from a stop-loss contract with claims processing services
Separating the claims processing services Both of the two criteria for identifying distinct services in paragraph B34 are met in this case: (a) the claims processing services, similar to the services to process the employee's claims on behalf of the employer, are sold as a standalone service without any insurance coverage; and (b) the claims processing services benefit the policyholder independently of the insurance coverage. Without the services, the policyholder would have to perform such services for its employees. Additionally, the criteria in paragraph B35 are not met because the cash flows associated with the claims processing services are not highly interrelated with the cash flows associated with the insurance coverage and the entity does not provide a significant service of integrating the claims processing services with the insurance components. Accordingly, the entity would separate the claims processing services from insurance contract and account for them using the proposals in [draft] IFRS X *Revenue from Contracts with Customers*.

Measurement on initial recognition of an insurance contract that the entity issues (paragraphs 12–16, 18–28, B36–B67 and B69–B82)

IE4 Paragraph 18 requires an entity to measure an insurance contract on initial recognition at the sum of:

(a) the amount of the fulfilment cash flows, measured in accordance with paragraphs 19–27, B36–B67 and B69–B82; plus

(b) any contractual service margin, measured in accordance with paragraph 28.

IE5 If the fulfilment cash flows are greater than zero, paragraph 15 requires the entity to measure the insurance contract at the amount of the fulfilment cash flows with the corresponding expense recognised in profit or loss. There would be no contractual service margin.

IE6 Paragraph 22 requires an entity to include in the fulfilment cash flows all cash inflows and cash outflows that relate directly to the fulfilment of the portfolio of contracts. Paragraph B66 provides examples of those cash flows, including directly attributable acquisition costs that can be allocated on a rational and consistent basis to the individual portfolios of insurance contracts.

IE7 The following example illustrates how an entity applies those requirements.

Example 4: measurement on initial recognition of an insurance contract that the entity issues

An entity issues insurance contracts that form a single portfolio, and coverage begins at the date that the contracts are issued. The entity estimates that the expected present value (EPV) of premiums from the policyholders equals CU900, and the risk adjustment equals CU30. Additionally:

- in Example 4A, the entity estimates that the EPV of future expenses equals CU720, which comprises:
    - CU690 of costs that relate directly to the portfolio of insurance contracts, comprising CU600 of expected claims and CU90 of directly attributable acquisition costs; and
    - CU30 of acquisition costs that are not directly attributable to the portfolio of insurance contracts.
- in Example 4B, the entity estimates that the EPV of future expenses equals CU1,020, which comprises:
    - CU990 of costs that relate directly to the portfolio of insurance contracts, comprising CU900 of expected claims and CU90 of directly attributable acquisition costs; and
    - CU30 of acquisition costs that are not directly attributable to the portfolio of insurance contracts.

At initial recognition, the entity measures the portfolio as follows:

	Example 4A	Example 4B
	CU	CU
EPV of cash outflows	690	990
EPV of cash inflows	(900)	(900)
Risk adjustment	30	30
Fulfilment cash flows	(180)	120
Contractual service margin	180	–
Insurance contract liability at initial recognition	**–**	**120**

Immediately after initial recognition, the first instalment of premiums is received (CU300) and the acquisition costs are paid (CU120 of which CU90 are directly attributable, and CU30 are not directly attributable, to the portfolio of contracts). The carrying amount of the insurance contract liability changes as a result of those cash flows as follows:

	Example 4A	Example 4B
	CU	CU
EPV of cash outflows	600	900
EPV of cash inflows	(600)	(600)

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Example 4: measurement on initial recognition of an insurance contract that the entity issues

Risk adjustment	30	30
Contractual service margin	180	–
Insurance contract liability immediately after initial recognition	**210**	**330**

The entity will recognise the following amounts in profit or loss:

	Example 4A	Example 4B
	CU	CU
Loss at initial recognition	–	(120)
Acquisition costs that are not directly attributable to a portfolio of contracts	(30)	(30)
Gain/(loss) recognised in the period	**(30)**	**(150)**

Measurement on initial recognition of a reinsurance contract held (paragraphs 41–42)

IE8 Paragraph 3 requires an entity to apply the [draft] Standard to a reinsurance contract that it holds. The entity would measure those contracts initially at the fulfilment cash flows plus a contractual service margin measured in accordance with paragraph 41. The following example illustrates how an entity measures the reinsurance contract held at initial recognition.

Example 5: measurement on initial recognition of a reinsurance contract held

An entity enters into a 30 per cent proportional reinsurance contract and, at the same time, issues corresponding underlying insurance contracts. The reinsurance coverage does not relate to events that occurred before the purchase of the reinsurance contract.

The entity measures the corresponding underlying insurance contract at initial recognition as follows:

	CU
EPV of cash outflows	900
EPV of cash inflows	(1,000)
Risk adjustment	60
Fulfilment cash flows	(40)
Contractual service margin	40
Insurance contract at initial recognition (immediately before premium received)	–

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Example 5: measurement on initial recognition of a reinsurance contract held

In relation to the reinsurance contracts held, the entity estimates the following:

(a) the EPV of cash inflows is CU270 (recovery of 30 per cent of the EPV of cash outflows of CU900 for the underlying insurance contracts);

(b) the risk adjustment is CU18 (the entity expects that the reinsurance contract held reduces 30 per cent of the risk arising from the underlying contracts and therefore measures the risk adjustment as 30 per cent of the risk adjustment of CU60 for the direct insurance contracts); and

(c) the EPV of cash outflows (the single reinsurance premium paid to the reinsurer, less ceding commissions received from the reinsurer) is:

(i) in Example 5A: CU300; and

(ii) in Example 5B: CU280.

Because the reinsurance coverage does not relate to events that occurred before the purchase of the reinsurance contract, the measurement of the asset that arises from the reinsurance contract held would be as follows:

	Example 5A	Example 5B
	CU	CU
EPV of cash inflows (recoveries)	270	270
EPV of cash outflows (premium ceded, net of ceding commission)	(300)	(280)
Risk adjustment	18	18
Fulfilment cash flows	(12)	8
Contractual service margin	12	(8)
Reinsurance contract at initial recognition	–	–

The effect on profit or loss will be the following:

Gain/(Loss) at initial recognition	–	–

Subsequent measurement of an insurance contract that the entity issues (paragraphs 29–32 and B68)

IE9 Paragraph 29 requires that the carrying amount of an insurance contract at the end of each reporting period shall be the sum of:

(a) the fulfilment cash flows at that date, measured in accordance with paragraphs 19–27, B36–B67 and B69–B82; and

(b) the remaining amount of the contractual service margin at that date.

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IE10 Paragraph 30 requires that, after initial recognition, an entity adjusts the contractual service margin for the difference between the current and previous estimates of the present value of future cash flows, if those future cash flows relate to future coverage and other future services. Because the contractual service margin for insurance contracts issued shall not be negative, the entity would recognise those unfavourable changes that exceed the carrying amount of the contractual service margin in profit or loss.

IE11 The following example illustrates how an entity applies those requirements.

Example 6: subsequent measurement of insurance contracts that the entity issues

An entity issues a portfolio of insurance contracts. The coverage period of three years starts when the contract is issued. For simplicity, the example assumes that the time value of money and the risk adjustment are immaterial and that all claims are paid when they are incurred.

At the start of the coverage period, the entity receives the total premiums of CU900 (no other premiums are expected) and estimates that the annual expected cash outflows would be CU200 (total CU600). However, the claims incurred for the second year differ from the expected claims and equals CU150 in Example 6A and CU450 in Example 6B. As a result, at the end of the second year, the entity revises its estimate for the third year. Thus, the cash flows in this example are as follows:

	Year 1	Year 2	Year 3
Expected cash outflow at initial recognition:	**CU**	**CU**	**CU**
In Examples 6A and 6B	200	200	200
Actual / expected cash outflows at the end of the second year:			
In Example 6A	–	150	150
In Example 6B	–	450	450

The entity estimates that the services will be provided equally over the coverage period. Consequently, in accordance with paragraphs 30–32, the contractual service margin would be recognised in profit or loss equally over the coverage period.

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Example 6: subsequent measurement of insurance contracts that the entity issues

Example 6A

In accordance with paragraphs 30–31, the entity would account for the changes in cash flows at the end of the second year as follows:

- the decrease of CU50 in the expected future cash flows would increase the contractual service margin by CU50 (and the revised contractual service margin is recognised in the statement of profit or loss and other comprehensive income on a straight line basis over the remaining coverage period); and
- the decrease of CU50 between the actual cash flows for the period compared to the previous estimates of those cash flows is an experience adjustment that does not relate to future coverage and would be recognised immediately in profit or loss.

Consequently, the entity would account for the insurance contract as follows:

	Initial recognition	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Expected cash outflows	600	400	150	–
Expected cash inflows	(900)	–	–	–
Fulfilment cash flows	(300)	400	150	–
Contractual service margin	300	200	150	–
Insurance contract liability	**–**	**600**	**300**	**–**

The reconciliation of the contractual service margin is as follows:

Changes in the contractual service margin	Initial recognition	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Opening balance		300	200	150
Recognised in profit or loss		(100)	(100)	(150)
Decrease in the estimate of future cash outflows added to margin		–	50	–
Closing balance	**300**	**200**	**150**	**–**

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Example 6: subsequent measurement of insurance contracts that the entity issues

The amounts determined in accordance with paragraph 60 are recognised in profit or loss as follows:

	Total	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Change in the contractual service margin that reflects the transfer of services	350	100	100	150
Change in estimates of future cash flows that do not adjust the contractual service margin	–	–	–	–
Difference between actual cash flows that occurred during the period and previous estimates of those cash flows (experience adjustment)	50	–	50	–
Profit/(loss)	**400**	**100**	**150**	**150**

Example 6B

In accordance with paragraphs 30–31, the entity would account for changes in cash flows at the end of the second year as follows:

- the increase in expected future cash flows of CU250 would:
  - decrease the remaining contractual service margin by CU100 to zero (because the contractual service margin cannot be negative for insurance contracts issued); and
  - be recognised as an immediate expense in profit or loss for the remaining amount of changes in future estimates of CU150.
- the increase of CU250 between the actual cash flows for the period compared to the previous estimates of those cash flows is an experience adjustment that does not relate to future coverage and would be recognised immediately in profit or loss.

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Example 6: subsequent measurement of insurance contracts that the entity issues

Consequently, the entity would account for the insurance contracts as follows:

	Initial recognition	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Expected cash outflows	600	400	450	–
Expected cash inflows	(900)	–	–	–
Fulfilment cash flows	(300)	400	450	–
Contractual service margin	300	200	–	–
Insurance contract liability	**–**	**600**	**450**	**–**

The reconciliation of the contractual service margin is as follows:

Changes in the contractual service margin	Initial recognition	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Opening balance		300	200	–
Recognised in profit or loss		(100)	(100)	–
Increase in the estimate of future cash outflows deducted from the margin		–	(100)	–
Closing balance	**300**	**200**	**–**	**–**

The amounts determined in accordance with paragraph 60 are recognised in profit or loss as follows:

	Total	Year 1	Year 2	Year 3
	CU	CU	CU	CU
Change in the contractual service margin that reflects the transfer of services	200	100	100	–
Changes in estimates of future cash flows that do not adjust the contractual service margin	(150)	–	(150)	–
Difference between actual cash flows that occurred during the period and previous estimates of those cash flows (experience adjustment)	(250)	–	(250)	–
Profit/(loss)	**(200)**	**100**	**(300)**	**–**

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Presentation of insurance contract revenue and expenses (paragraphs 56–59 and B89–B91)

IE12 Paragraph 56 requires an entity to present insurance contract revenue in the statement of profit or loss and other comprehensive income. Paragraphs B88–B91 provide guidance on how to measure insurance contract revenue.

IE13 Paragraph 58 states that insurance contract revenue and incurred claims presented in the statement of profit or loss and other comprehensive income shall exclude any investment components that, in accordance with paragraph 10(b), have not been separated.

IE14 Additionally, paragraph 74 requires the entity to disclose a reconciliation that shows how the carrying amounts of insurance contracts that are in an asset position and insurance contracts that are in a liability position are affected by cash flows and income and expenses recognised in profit or loss and other comprehensive income.

IE15 The following example illustrates how an entity applies these requirements.

Example 7: presentation of insurance contract revenue and expenses in the statement of profit or loss and other comprehensive income

This example uses the same assumptions as in Example 6. Therefore, the measurement of insurance contract balances at the end of each year and the amount of profit or loss recognised for each period is the same as in Example 6.

The entity concludes that, of the total cash outflows at the end of each year, CU100 are investment components. The changes in the expected cash outflows (as assumed in Example 6 and presented in the table below) do not affect the investment components. Thus, the cash flows in this example are as follows:

	Year 1	Year 2	Year 3
	CU	CU	CU
Expected cash outflows at contract inception:			
Examples 7A and 7B	200	200	200
Actual/expected cash outflows at the end of the second year:			
In Example 7A	–	150	150
In Example 7B	–	450	450
Repayments of investment components at the end of each year (Examples 7A and 7B)	(100)	(100)	(100)

Example 7A

Insurance contract liability (from Example 6A)	Year 1	Year 2	Year 3
	CU	CU	CU
Opening balance	–	600	300
Closing balance	**600**	**300**	**–**

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Example 7: presentation of insurance contract revenue and expenses in the statement of profit or loss and other comprehensive income

In accordance with paragraph B88, the entity measures the amount of insurance contract revenue that is presented in each reporting period as the difference between the opening and closing carrying amounts of the liability for the remaining coverage, excluding amounts that do not relate to coverage or other services for which the entity expects to receive consideration. The reconciliation of insurance contract balances required by paragraph 74 explains the amounts recognised in the statement of profit or loss and other comprehensive income, as follows:

Liability for the remaining coverage excluding amounts immediately recognised in profit or loss[(a)]	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance	–	600	300
Cash inflows	900	–	–
Insurance contract revenue[(b)]	(200)	(200)	(200)
Repayments of investment components	(100)	(100)	(100)
Closing balance	**600**	**300**	**–**

Liability for incurred claims	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance	–	–	–
Incurred claims	100	50	50
Repayments of investment components	100	100	100
Cash outflows	(200)	(150)	(150)
Closing balance	**–**	**–**	**–**

The entity presents the following amounts in the statement of profit or loss and other comprehensive income:

Statement of profit or loss and other comprehensive income	Total CU	Year 1 CU	Year 2 CU	Year 3 CU
Insurance contract revenue	600	200	200	200
Incurred claims[(c)]	(200)	(100)	(50)	(50)
Amounts immediately recognised in profit or loss	–	–	–	–
Profit/(loss)	**400**	**100**	**150**	**150**

Example 7B

Insurance contract liability (from Example 6B)	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance	–	600	450
Closing balance	**600**	**450**	**–**

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Example 7: presentation of insurance contract revenue and expenses in the statement of profit or loss and other comprehensive income

The reconciliation of insurance contract balances required by paragraph 74 explains the amounts recognised in the statement of profit or loss and other comprehensive income, as follows:

Liability for the remaining coverage excluding amounts immediately recognised in profit or loss	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance	–	600	300
Cash inflows	900	–	–
Insurance contract revenue[(b)]	(200)	(200)	(200)
Repayments of investment components	(100)	(100)	(100)
Closing balance	**600**	**300**	**–**

Liability for the remaining coverage related to amounts immediately recognised in profit or loss	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance	–	–	150
Losses immediately recognised in profit or loss	–	150	–
Unwind of losses when claims are incurred	–	–	(150)
Closing balance	**–**	**150**	**–**

Liability for incurred claims	Year 1 CU	Year 2 CU	Year 3 CU
Opening balance	–	–	–
Incurred claims[(c)]	100	350	350
Repayments of investment components	100	100	100
Cash outflows	(200)	(450)	(450)
Closing balance	**–**	**–**	**–**

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Example 7: presentation of insurance contract revenue and expenses in the statement of profit or loss and other comprehensive income

The entity presents the following amounts in the statement of profit or loss and other comprehensive income:

Statement of profit or loss and other comprehensive income	Total CU	Year 1 CU	Year 2 CU	Year 3 CU
Insurance contract revenue	600	200	200	200
Incurred claims	(800)	(100)	(350)	(350)
Losses immediately recognised in profit or loss	(150)	–	(150)	–
Unwind of losses when claims are incurred	150	–	–	150
Profit/(loss)	**(200)**	**100**	**(300)**	**–**

(a) In these examples, no amounts were immediately recognised in profit or loss at initial recognition or subsequently. Therefore, the reconciliation does not show how the entity treats such amounts.

(b) In accordance with paragraph B88, insurance contract revenue in Year 2 is calculated as the difference between the opening and closing balance of the liability for the remaining coverage excluding amounts immediately recognised in the profit or loss, ie CU600–CU300, adjusted for the repayment of the investment components of CU100. Insurance contract revenue could be also calculated (in accordance with paragraph B90) as the sum of the latest estimates of the expected claims and other expenses (CU100) plus the contractual service margin recognised in profit or loss (In Example 7A: CU100, see Example 6A; in Example 7B: CU100, see Example 6B) plus changes in the risk adjustment (assumed immaterial). The latest estimates of claims exclude the investment component of CU100.

(c) The repayment of the investment component of CU100 was excluded from incurred claims recognised each year.

Subsequent recognition of directly attributable acquisition costs (paragraphs 56–59 and B88–B91)

IE16 Paragraph B89(a) requires, for the purpose of measuring insurance contract revenue, that an entity allocate directly attributable acquisition costs over the coverage period in the systematic way that best reflects the transfer of services provided under that contract. Thus, insurance contract revenue includes an amount that equals to the portion of the premium that relates to recovering those costs.

IE17 Additionally, paragraph 32 requires an entity to recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of services that are provided under the contract.

IE18 The following example illustrates how an entity applies those requirements.

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Example 8: subsequent recognition of directly attributable acquisition costs

This example uses the same assumptions as in Example 4A for the measurement of the portfolio of the insurance contracts at initial recognition. For simplicity, assume that the time value of money is immaterial and that all expected expenses are incurred as expected and are paid immediately.

The coverage period for the portfolio of contracts is three years and starts when the contracts are issued. The assumptions related to this portfolio are as follows:

- Expected inflows of CU900 are paid in three instalments of CU300 at the beginning of each year.
- The risk adjustment at initial recognition equals CU30 (changes in risk will be recognised subsequently in profit or loss in accordance with paragraph 60(b). This example assumes that the entity recognises CU10 each year).
- Expected outflows comprise:
  - acquisition costs of CU120 (of which CU90 are directly attributable to the portfolio of insurance contracts and are paid at the beginning of the coverage period); and
  - expected claims of CU600 (CU200 incurred and paid each year).
- The contractual service margin at initial recognition is CU180 (ie CU900 – CU30 – CU90 – CU600).
- Both the directly attributable acquisition costs and the contractual service margin are recognised in profit or loss over the coverage period in the systematic way that best reflects the transfer of services provided under that contract, as follows:

	Total CU	Year 1 CU	Year 2 CU	Year 3 CU
Pattern of providing services (assumed)	100%	20%	30%	50%
Contractual service margin recognised in profit or loss	180	36	54	90
Directly attributable acquisition costs recognised in profit or loss	90	18	27	45

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Example 8: subsequent recognition of directly attributable acquisition costs

The entity presents the following amounts in the statement of profit or loss and other comprehensive income:

Statement of profit or loss and other comprehensive income	Total CU	Year 1 CU	Year 2 CU	Year 3 CU
Insurance contract revenue[(a)]	900	264	291	345
Incurred claims	(600)	(200)	(200)	(200)
Acquisition costs[(b)]	(120)	(48)	(27)	(45)
Profit/(loss)	**180**	**16**	**64**	**100**

(a) In accordance with paragraph B90, insurance contract revenue could be calculated as the sum of the latest estimates of the claims and other expenses, the directly attributable acquisition costs recognised in profit or loss in the period, the contractual service margin recognised in profit or loss in the period and the changes in the risk adjustment. For example in Year 1 insurance contract revenue of CU264 could be calculated as the sum of:
- CU200 of expected claims;
- CU18 of directly attributable acquisition costs recognised in profit or loss in the period;
- CU36 of contractual service margin recognised in profit or loss in the period; and
- CU10 of changes in the risk adjustment.

(b) In Year 1 the acquisition costs recognised in the statement of profit or loss and other comprehensive income equal CU48 and comprise:
- CU18 of directly attributable acquisition costs recognised in the statement of profit or loss and other comprehensive income for the period; and
- CU30 of acquisition costs paid in the period that are not directly attributable to the portfolio of insurance contracts.

Measurement of insurance contracts that were acquired in a portfolio transfer (paragraphs 43–44 and 46)

IE19 Paragraph 44 requires an entity to treat the consideration received or paid for a contract acquired in a portfolio transfer as a pre-coverage cash flow. In accordance with the general requirements of paragraph 18, the entity measures the insurance contract at the sum of the fulfilment cash flows and the contractual service margin, if any. The contractual service margin is measured, in accordance with paragraph 28, at an amount that is equal and opposite to the sum of the amount of the fulfilment cash flows and any pre-coverage cash flows.

IE20 The following example illustrates how an entity applies these requirements.

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Example 9: measurement of a portfolio of insurance contracts that were acquired in a portfolio transfer

An entity acquires a portfolio of insurance contracts in a portfolio transfer. The consideration received for the portfolio of contracts equals CU30. At initial recognition, the entity estimates the fulfilment cash flows (EPV of net cash flows adjusted for risk) as follows:

(a) in Example 9A: CU20. Thus, the sum of the fulfilment cash flows and the pre-coverage cash flows is CU(10) and the contractual service margin at initial recognition is CU10.

(b) in Example 9B: CU45. Thus, the sum of the fulfilment cash flows and the pre-coverage cash flows is CU15. The entity recognises a loss of CU15 because the contractual service margin cannot be negative.

At initial recognition, the entity measures the insurance contract liability as follows:

	Example 9A	Example 9B
	CU	CU
Fulfilment cash flows	20	45
Contractual service margin	10	–
Insurance contract at initial recognition	**30**	**45**
The effect on profit or loss will be:		
Loss at initial recognition	**–**	**15**

In Example 9A, the difference of CU10 between the consideration received and the fulfilment cash flows establishes the contractual service margin at initial recognition. Consequently, at initial recognition, the entity measures the portfolio at the consideration received of CU30.

In Example 9B, the entity measures the portfolio at the fulfilment cash flows, which equals CU45. There is no contractual service margin. The difference of CU15 between the consideration received and the fulfilment cash flows is recognised as a loss at initial recognition.

Measurement of insurance contracts that were acquired in a business combination (paragraphs 43–46)

IE21 Paragraph 44 requires an entity to treat the consideration received or paid for a portfolio of insurance contracts assumed in a business combination as a pre-coverage cash flow. The consideration received or paid is the fair value of the portfolio of contracts. In accordance with the general requirements of paragraph 18, the entity measures the insurance contract at the sum of the fulfilment cash flows and the contractual service margin, if any. The contractual service margin is measured, in accordance with paragraph 28, at an amount that is equal and opposite to the sum of the amount of the fulfilment cash flows and any pre-coverage cash flows. Paragraph 45 requires that the

initial measurement of contracts acquired in a business combination shall be used in determining any goodwill or gain from a bargain purchase in accordance with IFRS 3 *Business Combinations*.

IE22 The following example illustrates how an entity applies this requirement.

Example 10: measurement of insurance contracts that were acquired in a business combination

An entity assumes a portfolio of insurance contracts in a business combination. The fair value of the portfolio of the assumed insurance contracts (which is deemed to be a pre-coverage cash flow) is CU30. The entity estimates the fulfilment cash flows as follows:

(a) in Example 10A: CU20. Thus, the sum of the fulfilment cash flows and the pre-coverage cash flows is CU(10) and the contractual service margin at initial recognition is CU10.

(b) in Example 10B: CU45. Thus, the sum of the fulfilment cash flows and the pre-coverage cash flows is CU15. That measurement is used to determine any goodwill or gain from a bargain purchase in accordance with IFRS 3. There is no contractual service margin.

At initial recognition, the entity measures the insurance contract liability as follows:

	Example 10A	Example 10B
	CU	CU
Fulfilment cash flows	20	45
Contractual service margin	10	–
Insurance contract liability at initial recognition	**30**	**45**
The effect on profit or loss will be:		
Loss at initial recognition	**–**	**–**

In Example 10A, the difference of CU10 between the fair value and the fulfilment cash flows establishes the contractual service margin at initial recognition because it represents a net gain. Consequently, the entity measures the portfolio at initial recognition at its fair value of CU30.

In Example 10B, there is no contractual service margin because the difference between the fair value and the fulfilment cash flows does not represent a net gain. The entity measures the portfolio at the fulfilment cash flows of CU45 and uses that amount to determine the goodwill (or the gain from a bargain purchase) initially recognised in the business combination. As a result, that goodwill is CU15 higher (or the gain from a bargain purchase will be CU15 lower) than it would have been if the entity had measured the portfolio at its fair value of CU30.

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Measurement and presentation for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (paragraphs 33–34, 66 and B83–B87)

IE23 If the criteria in paragraph 33 are met, paragraph 34 requires an entity to determine the fulfilment cash flows that are expected to vary directly with returns on underlying items, and to measure those fulfilment cash flows on a different basis from the fulfilment cash flows that are not expected to vary directly with returns on underlying items. Paragraph B85 requires an entity to divide the cash flows in a way that identifies:

(a) the extent to which the cash flows are expected to vary with returns on underlying items; and

(b) the minimum fixed payment that the policyholder will receive.

IE24 Paragraph 66 specifies the presentation of changes in the fulfilment cash flows when an entity applies paragraphs 33–34. In particular, paragraph 66 requires an entity to recognise changes in the fulfilment cash flows that are not expected to vary with returns on underlying items, including those that are expected to vary with factors other than the underlying items and those that are fixed, in profit or loss and in other comprehensive income in accordance with paragraphs 60–65. In other words, for those cash flows:

(a) interest expense on the cash flows that are not expected to vary with returns on underlying items is recognised in profit or loss using the discount rates that were applied when the contract was initially recognised; and

(b) other comprehensive income is used to recognise the effects of changes in discount rates.

IE25 The following example illustrates these requirements.

Example 11: contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

Components of payments to policyholders

An insurance contract specifies payments to policyholders as follows:

(a) a guaranteed amount of CU1,000; plus

(b) 90 per cent of the increase in value of the pool of assets above CU1,000, ie: 90% × [the greater of the (value of the assets − CU1,000) and CU0].

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Example 11: contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

To identify the cash flows that are expected to vary directly with returns on the total assets to which the liability is linked, these components would be re-expressed as:

(a) 90 per cent of the assets; plus

(b) a fixed payment of CU100; plus

(c) the value of an option for the policyholder to put 90 per cent of the assets to the entity at maturity for a strike price of CU900.

Paragraphs 33–34 and 66(a) apply only to the first component, ie to the cash flows that are expected to vary directly with returns on underlying items. These fulfilment cash flows are measured by reference to the carrying amount of the underlying items, and the changes in these fulfilment cash flows are recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of the underlying items.

The second component of the cash flows is a fixed payment of CU100. Because this cash flow is not expected to vary with returns on underlying items, paragraphs 33–34 and 66(a) do not apply. This component is measured in accordance with paragraphs 18–32. The effects of changes in the discount rate that apply to CU100 are recognised in other comprehensive income in accordance with paragraph 64.

Paragraphs 33–34 and 44(a) do not apply to the option component of the liability (the value of the option) because the cash flows that result from that option component are expected to vary indirectly with returns on underlying items. This component is measured in accordance with paragraphs 18–32. The changes in the value of the cash flows are recognised in profit or loss in accordance with paragraph 66(b).

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Example 11: contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

Thus:

If the underlying pool of assets is measured at fair value through profit or loss:

(a) the changes in the fulfilment cash flows that are expected to vary directly with returns on underlying items are equal to 90 per cent of the change in the fair value of the underlying items. The change in those cash flows is recognised in profit or loss because paragraph 66(a) requires the change in those fulfilment cash flows to be recognised on the same basis as the recognition of changes in the value of the underlying items (through profit or loss).

(b) the minimum fixed payment to the policyholder is discounted using the discount rates specified in paragraph 25. In accordance with paragraph 60(h), interest expense on the fixed cash flows is recognised in profit or loss and is determined using the discount rates that reflect the characteristics of those cash flows that applied at the date that the contract was initially recognised. In accordance with paragraphs 64 and 66(c), the difference between the carrying amount of the insurance contract measured using the discount rates specified in paragraph 25, as determined at the reporting date, and the carrying amount of the insurance contract measured using the discount rates specified in paragraph 60(h) is recognised and presented in other comprehensive income.

(c) the changes in the carrying amount of the fulfilment cash flows related to the option are recognised in profit or loss in accordance with paragraph 66(b).

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Example 11: contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If the underlying pool of assets is measured at fair value through other comprehensive income:

(a) the changes in the fulfilment cash flows that are expected to vary directly with returns on underlying items are equal to 90 per cent of the change in the fair value of the underlying items. Those changes are presented consistently with the corresponding changes in underlying items in profit or loss or other comprehensive income in accordance with paragraph 66(a).

(b) the minimum fixed payment to the policyholder is discounted using the discount rates in accordance with paragraph 25. In accordance with paragraph 60(h), interest expense on the fixed cash flows is recognised in profit or loss and is determined using the discount rates that reflect the characteristics of those cash flows that applied at the date that the contract was initially recognised. In accordance with paragraphs 64 and 66(c), the difference between the carrying amount of the insurance contract measured using the discount rates specified in paragraph 25, as determined at the reporting date, and the carrying amount of the insurance contract measured using the discount rates specified in paragraph 60(h) is recognised and presented in other comprehensive income.

(c) the changes in the carrying amount of the fulfilment cash flows related to the option are recognised in profit or loss in accordance with paragraph 66(b).

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Example 11: contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If the underlying pool of assets is measured at amortised cost:

(a) the changes in the fulfilment cash flows that are expected to vary directly with returns on underlying items are equal to 90 per cent of change in the carrying amounts of the underlying items. Those changes are presented consistently with the corresponding changes in underlying items in profit or loss in accordance with paragraph 66(a).

(b) the minimum fixed payment to the policyholder is discounted using the discount rates in accordance with paragraph 25. In accordance with paragraph 60(h), interest expense on the fixed cash flows is recognised in profit or loss and is determined using the discount rates that applied at the date that the contract was initially recognised. In accordance with paragraphs 64 and 66(c), the difference between the carrying amount of the insurance contract measured using the discount rates specified in paragraph 25, as determined at the reporting date, and the carrying amount of the insurance contract measured using the discount rates specified in paragraph 60(h) is recognised and presented in other comprehensive income.

(c) the changes in the carrying amount of the fulfilment cash flows related to the option are recognised in profit or loss in accordance with paragraph 66(b).

Recognition and derecognition of balances on transition (paragraph C3)

IE26 Paragraph C3 specifies the adjustments that an entity makes on first application of the [draft] Standard.

IE27 The following example illustrates how an entity applies these requirements.

Example 12: recognition and derecognition of balances on transition

At the beginning of the earliest period presented, an entity recognised the following amounts in its financial statements in accordance with its previous accounting policies:

	CU
Deferred acquisition costs	150
Intangible assets arising from business combination	200
Insurance contract liability	(900)

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Example 12: recognition and derecognition of balances on transition

On the date of transition, the entity estimates:

(a) the insurance contract liability at the sum of the net expected present value of the cash flows (CU600), risk adjustment (CU10) and contractual service margin (CU30), ie as CU640; and

(b) the amount to be recognised in a separate component of equity (accumulated amount of other comprehensive income) to equal CU100. That amount is calculated as the difference between:

  (i) CU600, being the expected present value of the cash flows at the date of transition which was determined using current discount rates; and

  (ii) CU500, being the expected present value of the cash flows at the date of transition, discounted using the discount rates that applied when the portfolios were recognised.

The entity also concludes that the part of the intangible assets that arose from the previous business combination and that do not qualify as intangible assets equals CU125.

As a result, the entity recognises the following adjustments on the date of transition:

(a) a decrease in the insurance contract liability of CU260 (CU900 – CU640);

(b) a total decrease in assets of CU275 resulting from the derecognition of the deferred acquisition costs of CU150 and the derecognition of the intangible assets that do not meet the definition of an intangible asset of CU125;

(c) a total decrease in a separate component of equity (accumulated amount of the other comprehensive income) of CU100; and

(d) consequently, a net increase of CU85 in the retained earnings (CU260 – CU275 + CU100).

Measurement of insurance contracts on transition (paragraphs C4–C6)

IE28 Paragraphs C4-C6 specify a modified retrospective approach for determining the amounts recognised in the statement of financial position at the beginning of the earliest period presented and the amount of revenue to be earned on insurance contracts after the beginning of the earliest period presented. An entity applies that approach when it is not practicable to apply the [draft] Standard retrospectively.

IE29 The following example illustrates how an entity applies these principles.

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Example 13: measurement of insurance contracts on transition

An entity concluded that it does not have available all the information that it needs in order to apply the [draft] Standard retrospectively. The entity estimates the fulfilment cash flows at the beginning of the earliest period presented as follows:

	CU
Net expected present value of cash outflows (including the effect of time value of money equal to CU20)	280
Risk adjustment	100
Fulfilment cash flows	**380**

In accordance with paragraph C6, the entity estimated that at the date of the initial recognition:

(a) the net expected cash inflows equal CU200. This was determined as the actual cash inflows that occurred before the transition date, CU500, less the net expected cash outflows at the date of transition, CU300.

(b) the effect of the time value of money using the discount rate that would have been applied when the portfolio of contracts was initially recognised, estimated at the date of initial recognition, as CU50.

(c) the risk adjustment at the date of initial recognition is assumed to be the same as the risk adjustment at the date of transition, which is CU100.

(d) consequently, the contractual service margin measured at initial recognition (in accordance with paragraph 28) is CU250 (CU200 − CU50 + CU100).

Furthermore, the entity estimates the contractual service margin that would have been recognised as income in profit or loss before transition (in accordance with paragraph 32) as CU150. Consequently, the contractual service margin at the date of transition is CU100 (CU250 − CU150).

As a result, the carrying amount of the insurance contract liability at the date of transition equals CU480, which is calculated as the sum of the fulfilment cash flows estimated at the date of transition of CU380, and the contractual service margin of CU100.

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