Comprehensive proposals for Insurance Contracts accounting have been issued for comment

There is currently no comprehensive IFRS that deals with the accounting for insurance contracts.

IFRS 4 *Insurance Contracts*, published in 2004, is an interim standard that permits a wide range of practices and includes a "temporary exemption," which explicitly states that an entity does not need to ensure that its accounting policies are relevant to the economic decision-making needs of users of financial statements, or that those accounting policies are reliable.

This means that companies account for insurance contracts using different accounting models that have evolved in different jurisdictions according to the products and regulations prevalent in that jurisdiction.

As a result, there are substantial differences in the accounting policies used by different companies to account for insurance contracts. Accordingly, the International Accounting Standards Board is committed to issuing a standard on insurance contracts, which would improve financial reporting by providing more transparent, comparable information about the following:

- The effect on an entity's financial performance of the insurance contracts it issues;
- The way entities make profit or losses through underwriting risks and investing premiums from customers; and
- The nature and extent of risks that entities are exposed to as a result of issuing insurance contracts.

The exposure draft of the standard proposes that an entity should measure insurance contracts using a current value approach that incorporates all of the available information in a way that is consistent with observable market information. The proposals retain many of the characteristics of the 2010 exposure draft and reflect the IASB's view that insurance contracts blend financial elements with service elements in various proportions, depending on the type of contract.

It proposes that an entity should measure an insurance contract in a way that portrays a current assessment of the combined package of cash inflows and cash outflows generated by those elements, assuming that the entity expects to fulfil the liability by paying benefits and claims to policyholders as they become due. That measurement has two components:

a. A measurement of the amount, timing and uncertainty of the future cash flows that the entity expects the contract to generate as it fulfils the contract (that is, the fulfilment cash flows); and
b. A contractual service margin (known in the IASB's previous proposal as the "residual margin") that represents a current estimate of the profitability that the entity expects the contract to generate over the coverage period.

In this exposure draft, the IASB has revised various aspects of its requirements on the accounting for insurance contracts to:

a. Refine the approach to measurement, to propose that:
   (i) An entity would adjust the contractual service margin for changes in the estimate of the present value of future cash flows that relate to future coverage and other future services; and
   (ii) An entity should apply a specified measurement and presentation exception when a contract requires the entity to hold underlying items and specifies a link to returns on those underlying items.

b. Develop the approach to presentation, to propose that an entity should:
   (i) Present revenue and expenses in profit or loss for all insurance contracts; and
   (ii) Present interest expense to reflect the time value of money using an approach that is similar to that applied to financial instruments measured at amortized cost (that is, the statement of financial position would always show a current measure of insurance liability while the income statement would reflect the historical time value of money locked at inception; with changes in discount rate reflected in other comprehensive income, which would reverse over time as insurance liabilities are fulfilled).

c. Amend the approach to transition to propose that an entity should apply the draft standard retrospectively if practicable and with a modified retrospective approach otherwise.

The contractual service margin is recorded on contractual inception and eliminates any day-one gains, thereby representing unearned expected profit in the contract. The contractual service margin is determined as the excess, if any, of the expected present value of the cash inflows over the expected present value of future cash outflows plus the risk adjustment.

The contractual service margin will subsequently be released to profit or loss

over the coverage period in a way that best reflects the transfer of services under the contract. The contractual service margin will also be adjusted prospectively for changes in future expected cash flows relating to future coverage (that is, the contractual service margin should not be "locked in" at inception).

No limit has been imposed on the amount by which the contractual service margin can increase as a result of these changes. However, the contractual service margin cannot be negative. In this case, any changes in the excess of the carrying amount of the contractual service margin at the date of change should be recognized immediately in profit or loss.

On presentation, the exposure draft proposes that an entity presents revenue relating to the insurance contracts it issues in the statement of profit or loss and other comprehensive income. Insurance contract revenue should depict the transfer of promised services arising from the insurance contract in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The liability for the remaining coverage at the end of the reporting period represents the remaining obligation to provide services in the future.

Consequently, the change in the liability for the remaining coverage during the reporting period represents the coverage or other services that the entity provides in that period, assuming no other changes occur. As a result, the entity measures the amount of insurance contract revenue that is presented in each reporting period at the difference between the opening and closing carrying amounts of the liability for the remaining coverage, excluding changes that do not relate to coverage or other services for which the entity expects to receive consideration.

The Institute's financial reporting standards committee is deliberating on the proposals and will be preparing a submission to the IASB. In this connection, the Institute welcomes comments on all matters addressed in the exposure draft. Please provide your comments to Simon Riley, director of standard setting, by 25 September.

The article is contributed by the Institute's standard setting department.