Insurance Accounting Alert

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IASB discusses level of aggregation for insurance contracts

What you need to know

- The IASB held an education session to discuss the level of aggregation of insurance contracts for both participating and non-participating contracts, with emphasis on unlocking the CSM. No decisions were taken.
- The feedback provided by Board members at the February meeting on the level of aggregation will inform future discussions on the accounting model for participating contracts.

Overview

During its February meeting, the International Accounting Standards Board (IASB, or Board) continued redeliberations on its 2013 Exposure Draft Insurance Contracts (ED), with an education session on the level of aggregation (or unit of account). As part of the session, the Board discussed examples that illustrate the application of the principle of level of aggregation based on decisions made during previous meetings. Whilst the purpose of this session was to cover contracts with participation features (participating contracts), consideration was given to all types of contracts, in particular, the initial recognition and subsequent adjustment of the Contractual Service Margin (CSM). The staff did not ask the Board to make any decisions.

The story so far

The IASB's website provides information about tentative decisions made on the insurance contracts accounting model prior to this meeting, including:

- The cover note for the Insurance Board papers for the February meeting which contains a summary of progress so far[1]
- Further information on the project and the proposed model[2]

Level of aggregation

The staff reminded the Board of its previous tentative decision in June 2014 in respect of the level of aggregation for the measurement of insurance contracts. That decision noted that the objective is to measure contracts, both the current fulfilment cash flows and CSM, at the individual contract level. According to the staff, the objective implies that contracts should be aggregated in such a way that, both at initial recognition and subsequently, losses are recognised for unprofitable contracts and that this is not avoided by 'commingling' loss-making contracts with profitable ones. The staff also noted that discussions during the June 2014 meeting clarified that entities may aggregate contracts as long as they expect that, in doing so, they will meet the objective of the standard.

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[1] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/February/AP02-Insurance%20Contracts.pdf
[2] http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx

Building a better working world

The staff presented simple examples of contracts to illustrate how different approaches to aggregation could lead to inconsistencies with the objectives of the standard through the impact of aggregation on amortisation and the unlocking of the CSM.

Feedback from Board members

The Board members generally support the objective of measuring the current fulfilment cash flows and the CSM at the contract level because contractual rights and obligations arise from individual contracts. They believe the future standard should set principles for measuring components of an insurance contract and provide guidance for setting the levels of aggregation needed to meet the principles, rather than mandating a single level of aggregation for recognition and measurement. As such, the standard would not set a predefined level of aggregation. Rather, implementation of the level of aggregation would depend on facts and circumstances and different aggregation levels may be necessary for different purposes.

One Board member queried whether the key principle of aggregation should actually be to have the same outcome as accounting for an individual contract. This Board member noted this may push assessment to a very granular level of aggregation. The staff confirmed this was indeed the objective, which is consistent with the revenue recognition requirements of IFRS 15 *Revenue from Contracts with Customers* that apply to other industries.

The Board noted that significant concerns about the implications of the objective for the level of aggregation, and the staff examples illustrating this application, were raised by the insurance industry. Concerns have been raised that the proposed level of aggregation will not appropriately reflect the nature of insurance and the way that insurance risks and insurance business are managed. Another concern is that the proposal would also be complex to implement as the levels of aggregation that it implies would be too granular. Complexity could result from having to allocate the CSM to individual contracts and having to track expected cash flows at individual contract level to determine at which point a loss should be recognised because the CSM is no longer sufficient to absorb unfavourable changes in future estimates.

Board members generally recognise that existing practices for insurance contract accounting use the portfolio as the level of aggregation for measurement. There is a view that if existing approaches to aggregation do not satisfy the objectives of the standard, an entity may still employ its existing approach provided it employs additional techniques or methods to ensure that the outcome satisfies the objective. The staff added that the intention of the proposal is to require that entities only use reasonable and supportable information that is available without undue cost or effort.

A number of Board members commented that monitoring individual contracts would be impractical and, therefore, seemed open to providing further guidance on how to combine contracts into portfolios on the basis of factors such as similar risk, duration and profitability, subject to consistency with the objective of measurement at individual contract level. There was consensus amongst Board members that such guidance will be necessary to ensure consistency of application and that the implementation of the level of aggregation should be practicable.

Application to participating contracts

The staff explained that participating contracts contain several characteristics that need to be taken into account when setting the level of aggregation of contracts to reflect differences in the allocation of benefits between the insurer and policyholders. For example there are differences in:

- Explicit fees deducted before returns are passed on to policyholders
- The level of exposure to mortality risk between contracts
- The level of exposure to financial risks with significantly different embedded guarantees

The staff clarified that, for certain participating contracts, an entity has discretion over the amount and timing of cash flows passed on to policyholders. As the entity does not know at inception which contracts will receive more and which will receive less, the staff paper indicates it is appropriate to consider this feature when determining the CSM through aggregation of contracts.

As a result of the entity's discretion over the timing and amount distributed (either in cash payments or credits to contract balances) some current estimated future cash flow distributions may ultimately be allocated to future participants in the pool. The staff explained that fulfilment cash flows should include all expected returns on underlying items arising from existing contracts, regardless of whether the ultimate distribution of those returns are made to current or future policyholders.

This creates a present obligation for the entity to share a portion of the performance from existing contracts with the community of policyholders, current or future, irrespective of whether the performance is paid to an existing policyholder or to a policyholder who has yet to enter the community. Therefore, distributions arising from existing contracts to future policyholders are no different in principle from distributions to existing policyholders under the measurement model. The staff commented that this notion should not be confused with aggregating the CSM of existing and future policyholders.

Board members commented that further clarification is needed for participating contracts, particularly, on how discretionary participation features and 'mutualisation' of risks between policyholders and the insurer should be included in setting the level of aggregation.

Furthermore, the Board should consider how its thinking on this topic would apply to contracts accounted for under the premium allocation approach, in particular, the application of the onerous contract test.

How we see it

The level of aggregation is a critical topic that requires careful consideration for all types of contracts. Industry participants have expressed concerns over the IASB's approach to aggregation and unit of account. The IASB needs to find a balance between its individual contract measurement objective, ensuring that loss-making contracts are not obscured by the profits from unrelated profitable contracts, on the one hand and the risk-sharing nature of insurance and the cost and feasibility of maintaining accounting records on the other. Understanding the role of contractual features such as risk pooling, 'mutualisation' and company discretion in the application guidance will be key to achieving this balance.

What's next?

While the Board has essentially completed the development of the model for non-participating contracts during previous meetings, issues relating to its model for insurance contracts with participating features have yet to be resolved.

Deliberations on contracts with participating features are likely to continue during the first half of 2015, including the resolution of the concerns over level of aggregation. The Board's next meeting on insurance contracts will be in March. The topics have not yet been announced, but will likely cover further redeliberations on the open points above. The IASB expects to publish a final standard in late 2015.

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