STAFF PAPER

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IASB Meeting

Project	**Insurance contracts**
Paper topic	Disclosure of the effect of changes in discount rates

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Purpose of paper

1. In agenda paper 2D the staff recommended that the Board confirm the proposals in the 2013 Exposure Draft *Insurance Contracts* ('the ED') that an entity should present in other comprehensive income ('OCI') the effect of changes in discount rates, subject to developing an option that would permit entities to present that amount in profit or loss ('P&L'). In agenda paper 2E the staff recommended that an entity should choose as its accounting policy whether to present the effect of changes in discount rates on the measurement of insurance contracts in P&L or OCI and apply the accounting policy to all contracts within a portfolio.

2. This paper considers disclosures that would enable users of financial statements to compare the effect of changes in discount rates on the measurement of insurance contracts between entities that present the effect of changes in discount rates in P&L and those that present such changes in OCI.

3. The paper does not discuss:

   (a) The use of OCI for insurance contracts that provide policyholders with returns from underlying items (e.g., unit linked, universal life, variable annuity, etc.);

   (b) The reference date for determining locked-in discount rates for contracts measured using the premium allocation approach; or

(c) The interaction between any optional use of OCI and unlocking the contractual service margin.

These topics will be discussed at a future meeting

Staff Recommendations

4. The staff recommend that entities disclose the following information:

   (a) *For all portfolios of insurance contracts:* Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:

      (i) the amount of interest accretion determined using current discount rates,

      (ii) the effect on the measurement of insurance contracts of changes in discount rates in the period, and

      (iii) the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period, measured using discount rates that applied on initial recognition of insurance contracts, and when measured at current rates.

   (b) *In addition, for portfolios of insurance contracts for which the effect of changes in discount rates are presented in other comprehensive income:* Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:

      (i) interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in P&L for the period; and

      (ii) the movement in OCI for the period.

5. After the IASB has considered the treatment of the contractual service margin for participating contracts, staff will consider the tentative decisions together to see if the tentative decisions reached for non-participating contracts should be revisited, or vice versa

Background

6. The ED proposed the mandatory use of OCI to present the effect of changes in discount rates on the measurement of insurance contracts. The ED proposed that, for cash flows that do not vary directly with returns on underlying items[1], interest expense in P&L is based on discount rates that applied at the date that an insurance contract was initially recognised. The difference between discounting the carrying amounts of insurance contracts at discount rates locked-in at initial recognition and rates that applied at the reporting date would be presented in accumulated OCI.

7. The proposals in the ED were intended to help users of financial statements to understand different components of changes in the measurement of fulfilment cash flows. Thus, the ED proposed to separate the effect of changes in discount rates on the measurement of insurance contracts since the time of initial recognition of an insurance contract from other changes in estimates that would affect the amounts paid to policyholders. Those other changes in estimates included, for example, changes in mortality assumptions and assumptions about the frequency and severity of claims. The effect of changes in estimates that affect amounts paid to policyholders are reported in profit or loss or adjust the contractual service margin, depending on whether those estimates relate to future coverage and other future service.

8. The ED proposed mandatory use of OCI. However, agenda paper 2E recommends that an entity should choose as its accounting policy whether to present the effect of changes in discount rates on the measurement of insurance contracts in P&L or OCI and apply the accounting policy to all contracts within a portfolio. As a result, to the extent that entities select accounting policies to present the effect of changes in discount rates in P&L, the effect of changes in discount rates would not be separately reported. That would diminish the comparability of performance between entities and the performance of contracts within entities measured under different approaches. In this paper the staff consider disclosures

[1] The treatment of cash flows that are expected to vary directly with returns on underlying items are outside the scope of this paper.

that can help explain the effect of changes in discount rates and enable comparison of performance between the two approaches.

Staff analysis

9. The rest of the paper:

   (a) Summarises what would be reported in P&L, OCI and the statement of financial position by entities adopting either a P&L or OCI approach to presenting the effects of changes in discount rates in paragraphs 10 to 16

   (b) Proposes additional disclosures about the effect of changes in discount rates in paragraphs 17 to 20.

What would be reported under OCI and profit or loss approaches

10. Regardless of whether an entity chooses to present changes in discount rates in OCI or in P&L, the carrying amounts for insurance contracts reported in the statement of financial position are the same. This is because the contract is always measured using cash flows discounted at current rates that apply at the reporting date. In addition, the amount of total interest expense in total comprehensive income is the same under both approaches.

11. The total interest expense can be analysed into the following components:

   (a) the accretion of interest in the reporting period determined using current discount rates;

   (b) the effect on the measurement of insurance contracts of changes in discount rates in the period (ie, revaluation of the liability at the end of the period as a consequence of any change in the discount rate between the beginning and the end of the period); and

   (c) the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period (measured using discount rates that applied on initial recognition of insurance contracts) and when measured at current rates.

12. The amount in paragraph 11(c) arises because paragraphs 30(c) and 30(d) of the ED require that the present value of the difference between the current and previous estimate of cash flows that relate to future coverage and other future services adjust the contractual service margin – subject to the contractual service margin never being allowed to be negative. When there is a change in estimates of cash flows, an amount is recognised in OCI, representing the difference in the present value of the change in cash flows determined using the rate that applied when the revised estimate of cash flows was made, and the present value of the change in cash flows determined using the rate that applied when the contract was initially recognised.[2]

13. Regardless of whether an entity chooses to present the effect of changes in discount rates in P&L or OCI, the same amounts are included in total comprehensive income. However, different amounts are presented in P&L and OCI, as follows:

    (a) For the P&L approach, these amounts would be presented as a single combined interest expense in P&L;

    (b) For the OCI approach, interest accretion expense in P&L is calculated using locked-in discount rates, and the movement in OCI is the difference between the total interest expense in total comprehensive income and interest accretion expense calculated at locked-in rates.

14. The components of P&L and movements in OCI are shown in the following table:

[2] The staff may consider the interaction of adjusting the contractual service margin and the potential optional use of OCI at a later meeting of the Board.

	Effect of changes in discount rates in P&L		Effect of changes in discount rates in OCI	
	CU	CU	CU	CU
Profit or loss:				
Interest accretion at locked-in rates			A	
Interest accretion at current rates	B			
Effect of change in discount rates in the period	C			
Difference between the measurement of amounts that adjust the contractual service margin at locked-in and current discount rates	D			
		Z		A
Movements in other comprehensive income:				
Interest expense at current rates			B	
Less: interest accretion at locked-in rates			(A)	
Effect of change in discount rates in the period			C	
Difference between the measurement of amounts that adjust the contractual service margin at locked-in and current discount rates			D	
				E
Total comprehensive income		Z		Z

15. When an entity chooses to present the effect of changes in discount rates in OCI, accumulated OCI at each reporting date would be the difference between measuring insurance contracts at locked-in discount rates and current rates as at the reporting date.

16. The staff present proposed additional disclosures below. The staff present a numerical example of the disclosures in Appendix A.

Proposed additional disclosures

17. The staff propose that for both the OCI approach and the P&L approach, entities should analyse total interest expense into the component parts shown in paragraph

14, ie Z=B+C+D. In the staff's view this would provide useful information to understand the interest expense component of total comprehensive income.

18. The amounts ascribed to each component of total interest expense will depend upon the order in which the calculations are performed, ie, the accretion of interest, adjustments for the effects of changes in expected cash flows, and the effect of changes in discount rates in a period. The staff do not propose to specify a required order as they believe that this would be arbitrary and a chosen order of calculation might not be appropriate in all circumstances. The staff would expect entities to apply a consistent order in which they perform these calculations to all insurance contracts in each reporting period and between reporting periods. Providing the disclosures that the staff are recommending would mean that entities would need to perform discounting calculations for expected cash flows using current discount rates that apply at the beginning and end of each reporting period. The staff do not believe that their proposal for additional disclosures would lead to significant incremental effort or complexity in comparison with determining expected cash flows and the application of locked-in discount rates. The staff believe that their proposal represents the minimum effort required to provide users with information about the effect of changes in discount rates in a period and would form part of most analyses of movements in the present value of expected future cash flows typically performed as a control over the accuracy of the measurement of insurance contracts.

19. In addition, the staff propose that when an entity applies the OCI approach, it should analyse the total interest expense in the period into the interest expense presented in P&L in the period and the movement in OCI. That amount will show how the interest expense presented in profit and loss relates to the total interest expense.

20. The staff are not proposing that entities disclose interest expense at locked-in discount rates for contracts for which the P&L approach applies. The staff believe that achieving this level of comparability would be onerous for entities that use the P&L approach, because it necessitates the tracking of locked in discount rates. The staff notes that a reduction in complexity was one of the factors that led the staff to recommend an option to use the P&L approach. Instead, the staff thinks that the disclosure of the effects of changes in discount rates in each period (ie C

in the table in paragraph 14) will enable users of financial statements to separate the effects of changes in discount rates in the period from other underwriting effects.

Question for Board members

Does the Board agree that entities should disclose the following information:

(a) *For all portfolios of insurance contracts:* Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:

 (i) the amount of interest accretion determined using current discount rates,

 (ii) the effect on the measurement of the insurance contract of changes in discount rates in the period, and

 (iii) the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period, measured using discount rates that applied on initial recognition of the insurance contract, and when measured at current rates.

(b) In addition, for portfolios of insurance contracts for which the effect of changes in discount rates are presented in other comprehensive income: Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:

 (i) interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in profit or loss for the period; and

 (ii) the movement in other comprehensive income for the period

Appendix A: Illustrative example of proposed disclosures

A1. The following example illustrates the staff's proposed disclosures for insurance contracts for which the effects of changes in discount rates are presented in either OCI or profit or loss. The assumptions underpinning the example are as follows:

(a) A portfolio of insurance contracts with expected payments of CU1,000,000 at the end of 2010 as at the end of 2000;

(b) Expected payments at the end of 2010 increase to CU1,200,000 during 2001;

(c) Locked-in discount rate to measure 2010 cash flows of 10% pa;

(d) Current discount rate to measure 2010 cash flows as at the end of 2000 of 9% pa; and

(e) Current discount rate to measure 2010 cash flows at the end of 2001 of 8% pa.

A2. The staff have provided references to lines and columns in the example to help readers understand how the figures have been calculated.

Workings	**Column 1** **Locked-in rate**	**Column 2** **31/12/2000 current rate**	**Column 3** **31/12/2001 current rate**
A) Discount rate	10%	9%	8%
B) Present value of expected cash flows at 31/12/2000	385,542	422,410	
C) Present value of expected cash flows at 31/12/2001	508,917	552,514	600,299
D) Interest accretion in 2001 (row A x row B)	38,555	38,018	
E) Present value of CU200k increase in expected cash flows as at 31/12/2001	84,820	92,086	

A3. In this illustrative example, the staff have calculated the components of interest expense in the following order:

a. Accretion of interest at the current rate at the beginning of the period

b. Measurement of the effects of changes in expected cash flows

c. Measurement of the effect of a change in discount rate in the period.

A4. Column 1 relates to insurance contracts for which the effects of changes in discount rates are presented in P&L. Column 2 relates to insurance contracts for which the effects of changes in discount rates are presented in OCI.

2001 financial statements		**Column 1**		**Column 2**
Effect of change in discount rates on insurance contract measurement	Ref	Profit or loss approach	Ref	OCI approach
Extract from statement of comprehensive income				
F) Profit or loss: Interest accretion expense	C3-B2 - L1	93,069[3]	D1	38,555
G) Movement in OCI		-	J2	54,514
Extract from statement of financial position				
H) Accumulated OCI debit balance b/f			B2-B1	36,868
J) Movement in OCI in the period				54,514
K) Accumulated OCI debit balance c/f			C3-C1	91,382
Extract from disclosure of movement in CSM				
L) Adjustment (debit) to CSM	E1	84,820	E1	84,820

[3] The measurement of liabilities increases by CU177,889 from CU422,410 to CU600,299 in the period. CU84,820 adjusts the contractual service margin. The remaining amount of CU93,069 is presented in P&L as part of interest expense in the period. The staff propose that a breakdown of this amount is disclosed – as shown overleaf.

Proposed disclosures in 2001		**Column 1**		**Column 2**
Effect of change in discount rates on insurance contract measurement	Ref	Profit or loss approach	Ref	OCI approach
Analysis of interest expense in profit or loss / total comprehensive income				
M) Interest accretion at current rate b/f	D2	38,018	D2	38,018
N) Difference between the measurement of amounts that adjust the CSM at locked-in and current discount rates	E2-E1	7,266	E2-E1	7,266
P) Effect of change in discount rates in period	C3-C2	47,785	C3-C2	47,785
Q) Interest expense in period		93,069		93,069
Reconciliation of total interest expense to the statement of comprehensive income				
R) Profit or loss: Interest accretion expense			F2	38,555
S) Movement in OCI			G2	54,514
T) Interest expense in total comprehensive income				93,069