IFRS

STAFF PAPER

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Accounting Standards Advisory Board
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Project	**Insurance Contracts**		
Paper topic	Use of OCI for contracts with participating features		

CONTACT(S)	Conor Geraghty	cgeraghty@ifrs.org	+44 (0)20 7246 0553
	Joanna Yeoh	jyeoh@ifrs.org	+44 (0)20 7462 6481
	Andrea Pryde	apryde@ifrs.org	+44 (0)20 7246 6491

Purpose of paper

1. This paper considers:

   (a) whether, for contracts with participating features, the effects of changes in discount rates should, or may, be presented in Other Comprehensive Income (OCI) (paragraphs 7 to 14);

   (b) the applicability, and hence scope, of the book yield and effective yield approaches (paragraphs 15 to19); and

   (c) whether adaptations are needed to the general model for the following contracts:

      (i) participating contracts that the IASB believes should not be accounted for using either the book yield or effective yield approaches; and

      (ii) participating contracts that the IASB believes could be accounted for using the effective yield approach but should not be accounted for using the book yield approach (paragraphs 20 to 27).

2. This paper should be read in conjunction with Agenda Paper 5A *Book yield and effective yield approaches to presenting interest expense in profit or loss*, Agenda Paper 5B *Illustrative examples of book yield and effective yield approaches* and

Agenda Paper 5D *Should there be a book yield approach for determining interest expense in profit or loss?*.

3. Although this paper includes questions for the board, these questions are for direction only. The staff intends to ask for decisions on contracts with participating features at a future meeting.

Staff recommendations

4. The staff recommend that:

   (a) For contracts with participating features, an entity should choose to present the effect of changes in discount rates in profit and loss or in other comprehensive income as its accounting policy, and should apply that accounting policy to all contracts within similar portfolios.

   (b) That an entity should apply the OCI approach applicable to contracts with no participating features to insurance contracts where the cash flows that vary with investment returns on underlying items are **not** a substantial proportion of the total benefits to the policyholder over the life of the contracts.

   (c) That an entity should apply the effective yield approach described in Agenda Papers 5A and 5B to contracts where the cash flows that vary with investment returns on underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contracts, and:

      (i) the returns to be passed to the policyholder do not arise from the underlying items that the entity holds;

      (ii) the policyholder will not receive a substantial share of the total return on the specified underlying items; or

      (iii) applying the book yield approach would create or increase accounting mismatches in profit or loss between the insurance contract and the underlying items.

5. Agenda Paper 5D considers the presentation of interest expense for contracts where the cash flows that vary with investment returns on underlying items are a

substantial proportion of the total benefits to the policyholder over the life of the contracts and:

(a) the returns to be passed to the policyholder arise from the underlying items that the entity holds;

(b) the policyholder will receive a substantial share of the total return on the specified underlying items; and

(c) applying the book yield approach would reduce or eliminate accounting mismatches in profit or loss between the insurance contract and the underlying items.

6. The staff reminds the IASB that the recommendations in this paper are for the purpose of direction, and the staff will confirm all tentative decisions taken at this meeting when considering all the decisions relating to contracts with participating features as a whole.

Extending the use of OCI for presenting the effects of changes in discount rates to contracts with participating features

7. This section discusses whether to extend the decision that the effects of changes in discount rates for participating contracts should, or may, be presented in OCI from contacts *without* participating features to contracts *with* participating features.

Contracts without any participating features

8. For contracts with no participating features, the IASB decided that presenting the effects of discount rate changes in OCI could produce useful information by separating underwriting results from investment results in some situations. The IASB believed that this decision would increase the transparency about the performance of insurance contracts by segregating in OCI the effects of changes in discount rates that are expected to unwind over time from other changes in the

measurement of insurance contracts[1]. Paragraph 119 of the Basis for Conclusions to the 2013 ED stated:

> ..the IASB was persuaded that entities should segregate the effects of changes in the discount rate that are expected to unwind over time from other gains and losses, so that users of financial statements could better assess the underwriting and investing performance of an entity that issues insurance contracts. The IASB believes that such segregation could be achieved by approximating an amortised cost view of the time value of money to be recognised in profit or loss.

9. Thus, the IASB acknowledged that, when measurement inconsistencies do not result in a lack of faithful representation, it could be appropriate to measure financial assets at fair value through other comprehensive income (FVOCI) or amortised cost and present the effects of changes in discount rates on the measurement of insurance contracts in OCI.

10. Furthermore, the IASB permitted an entity to choose to present the effects of discount rates in profit or loss and OCI. Doing so enables entities to eliminate accounting mismatches in profit or loss, whilst acknowledging that constituents have different views on the costs and benefits of a fair value or cost-based approach to the measurement of assets backing insurance liabilities and the presentation of the effects of changes in discount rates.

11. Thus, when an entity chooses to present the effects of changes in discount rates in OCI for contracts without participating features, that entity should recognise:

   (a) in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised; and

   (b) in other comprehensive income, the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance

[1] ie the measurement of cash flows at discount rates locked-in at contract inception and current rates will converge on the nominal amount of expected cash flows as the settlement date approaches.

contract measured using the discount rates that applied at the date the contract was initially recognised.

Contracts with participating features

12. The IASB's strategy for the accounting model for contracts with participating features is to adapt the accounting model for contracts without participating features as appropriate. Applying this strategy, entities would have an accounting policy choice to recognise in OCI or profit or loss the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract measured using the discount rates that applied at the date the contract was initially recognised. However, the approach applied to contracts without participating features would need to be adapted to allow resetting of discount rates used to determine interest expense in profit or loss to reflect the presence of a participating feature. This is because the discount rate at inception of the contract would need to be reset to reflect the fact that the entity expected the payments to policyholders to vary when the investment returns from underlying items vary.

13. Extending the decision for permitting the effects of discount rate changes to be recognised in profit or loss or OCI for contracts with no participating features to contracts with participating features would avoid differences in the treatment of contracts that fall either side of the boundary, or boundaries, of eligibility for the proposed OCI mechanics. Such differences may be difficult to explain. Additionally, the staff believes that the IASB's reasoning in paragraphs 8 and 10 apply equally to contracts with participating features. Accordingly, the staff believes that, for contracts with participating features, entities should be able to choose to present the effect of discount rate changes in OCI or profit or loss.

14. The rest of this Agenda Paper, and Agenda Paper 5D, considers the appropriate mechanics for the entities that choose to present the effects of discount rate changes in OCI.

Question 1—Use of OCI to present the effect of changes in discount rates
Does the IASB agree that, for contracts with participating features, an entity

should choose to present the effect of changes in discount rates in profit and loss or in other comprehensive income as its accounting policy, and should apply that accounting policy to all contracts within a portfolio?

Applicability of book yield and effective yield approaches

15. As described in Agenda Paper 5A, the IASB directed the staff to consider approaches, including the effective yield and book yield approaches, that would require an entity to apply the same discount rate to all the cash flows of the contract. The IASB noted that an approach that applied a discount rate that reflected dependence on underlying items to all the cash flows of the contract would need to be restricted to contracts for which the predominant nature of the cash flows in the contract would be those that vary with investment returns on underlying items. Accordingly, at the July 2014 Board meeting, the IASB tentatively decided that it would consider requiring or permitting an entity to apply an effective yield approach (which updates the locked in rate to reflect changes in underlying items for all the cash flows in the contract) only when the cash flows in the contract that vary with investment returns on underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contracts.

16. At the June 2014 Board meeting, the IASB further decided to restrict the circumstances in which it would consider permitting or requiring an entity to apply a book yield approach. In other words, there would be fewer contracts to which a book yield approach could be applied, compared to an effective yield approach. This is because the IASB believes that:

    (a) the book yield approach would produce useful information only when there is a clear relationship between the underlying items recognised on the balance sheet and the amounts passed on to the policyholder. This means that the returns to be passed to the policyholder must arise from the underlying items that the entity holds; and

    (b) the benefits of the book yield approach (ie reduction in accounting mismatch) outweigh the costs of the additional complexity needed to track the accounting returns of underlying items only when the policyholder will receive a substantial share of the total return of the underlying items.

17. Accordingly, the IASB decided that it would consider permitting or requiring an entity to apply a book yield approach only to contracts with the following features:

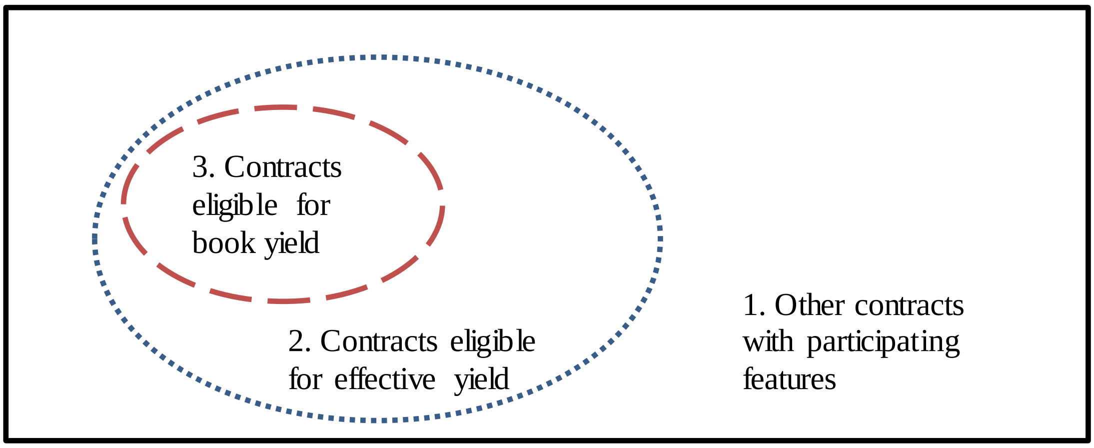
    (a) when the returns to be passed to the policyholder arise from the underlying items that the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payment to policyholder); and

    (b) the policyholder will receive a substantial share of the total return on the specified underlying items.

18. In addition, the staff propose that there should be an addition criteria for the book yield approach, that follows from the objective for the book yield approach described in Agenda Paper 5A in paragraph 36. Because this objective is to reduce accounting mismatch, the staff believes that the book yield approach should be applied only when doing so would reduce accounting mismatch. As we describe in the table in paragraph 23 in Agenda Paper 5A, this might not be feasible for when some of the underlying items are accounted for at cost or FVOCI.

19. The diagram below summarises these conclusions. It shows that the IASB would consider the book yield as applying to a relatively narrow set of contracts. The effective yield approach, which could apply to a wider set of contracts would nonetheless not apply to all contracts with participating features (ie it would not apply when the participating features are not a substantial feature of the contract).

Contracts with participating features



Question 2—Applicability of book yield and effective yield approaches
Do IASB members have questions or comments on the staff's analysis on the interaction between the proposed scope of the book yield and the effective yield approaches?

Adaptations to the general model needed for contracts with participating features

20. This section considers whether adaptations to the proposals for interest expense in the general model needed for the following:

    (a) Participating contracts that the IASB believes should not be accounted for using either the book yield or the effective yield approaches (in sector 1 of the diagram in paragraph 19) in paragraphs 22-24; and

    (b) Participating contracts that the IASB believes could be accounted for using the effective yield approach but should not be accounted for using the book yield approach (sector 2 of the diagram in paragraph 19) in paragraphs 25-27.

21. Agenda Paper 5D considers whether the IASB should permit or require a book yield approach for the presentation of interest expense for contracts meeting the criteria described in paragraph 5 (ie the contracts in sector 3 of the diagram in paragraph 19).

Participating contracts that the IASB believes should not be accounted for using either the book yield or the effective yield approaches (Sector 1)

22. Some contracts have participating features, but would not be eligible for the book yield and effective yield approaches because the cash flows in the contract that vary with investment returns on underlying items are not a substantial proportion of the total benefits to the policyholder over the life of the contracts. The staff propose that the interest expense and OCI for these contracts would be determined using the same approach as contracts without participating features. In other words, there would be no adaptations made to the general model for the interest expense in P&L for these contracts. This would mean that interest expense in profit or loss would be determined using discount rates locked-in at initial recognition of the contracts and that the difference between the carrying amount of the insurance contract measured at the discount rates that applied at the reporting date and rates that applied at initial recognition would be recognised in OCI.

23. This approach would be consistent with applying proposals appropriate for the predominant cash flows in the contract, thus addressing the concern that it would be too complex to require splitting of cash flows with different characteristics within a contract. As a result, if an entity chose the OCI approach as its accounting policy, that entity would apply discount rates locked-in at initial recognition of the contract to all of the expected cash flow in the contracts – including those that vary with returns on underlying items.

24. The staff do not believe that insurers issue a significant number of contracts within this category.

Question 3—Adaptations to interest expense for contracts with participating features when the cash flows that vary with investment returns on underlying items are not a substantial proportion of the total benefits to the policyholder
Does the IASB agree that an entity should apply the OCI approach applicable to contracts with no participating features to participating contracts where the cash flows that vary with investment returns on underlying items are **not** a substantial proportion of the total benefits to the policyholder over the life of the contracts?

Participating contracts that the IASB believes could be accounted for using the effective yield approach but should not be accounted for using the book yield approach (Sector 2)

25. Contracts within this category are those in which cash flows that vary with returns on underlying items **are** a substantial proportion of total benefits to policyholders over the life of the contract, but one or more of the following criterion are met:

(a) the entity does not hold the underlying items;

(b) the policyholder will not receive a substantial share of the total return on the specified underlying items; or

(c) applying the book yield approach would create or increase accounting mismatches in profit or loss between the insurance contract and the underlying items. For example, this occurs in some circumstances when the underlying items are accounted for at cost or FVOCI (as described in the table in paragraph 23 in Agenda Paper 5A).

26. The staff proposes that for such contracts, an effective yield approach should be applied to reflect the variable rate nature of the predominant cash flows. This is because the cash flows that vary with investment returns from underlying items are by definition significant for these contracts and, as previously discussed by the IASB in developing the 2013 ED, using a locked-in discount rates without a reset would produce profits and losses that are difficult to explain. Resetting the discount rate, as would be the case in the effective yield approach would reflect the fact that the entity expected the payments to policyholders to vary when the investment returns from underlying items vary.

27. The staff notes that such contracts would include, for example, some universal life contracts.

Question 4—Adaptations to interest expense for contracts with participating features when the cash flows that vary with investment returns on underlying items are a substantial proportion of the total benefits to the policyholder
Does the IASB agree that an entity should apply the effective yield approach described in Agenda Papers 5A and 5B to contracts where the cash flows that vary with investment returns on underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contracts, and: (i) the returns to be passed to the policyholder do not arise from the underlying items that the entity holds; (ii) the policyholder will not receive a substantial share of the total return on the specified underlying items; or (iii) applying the book yield approach would create or increase accounting mismatches in profit or loss between the insurance contract and the underlying items?

28. (Agenda Paper 5D considers the presentation of interest expense for contracts where the cash flows that vary with investment returns on underlying items are a

substantial proportion of the total benefits to the policyholder over the life of the contracts and:

(a) The returns to be passed to the policyholder arise from the underlying items that the entity holds;

(b) The policyholder will receive a substantial share of the total return on the specified underlying items; and

(c) applying the book yield approach would reduce or eliminate accounting mismatches in profit or loss between the insurance contract and the underlying items.

These are the contracts in Sector 3 in the diagram in paragraph 19.)