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STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Should there be a book yield approach for determining interest expense in profit or loss?		

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Purpose of paper

1. This paper considers whether the book yield approach should be used to determine 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 the accounting mismatches in profit or loss between the insurance contract and the underlying items.

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 5C *Use of OCI for contracts with participating features*.

Staff recommendations

3. When an entity presents the effect of changes in discount rates in other comprehensive income, the staff recommends **not** to allow the use of the book yield approach for the presentation of interest expense.

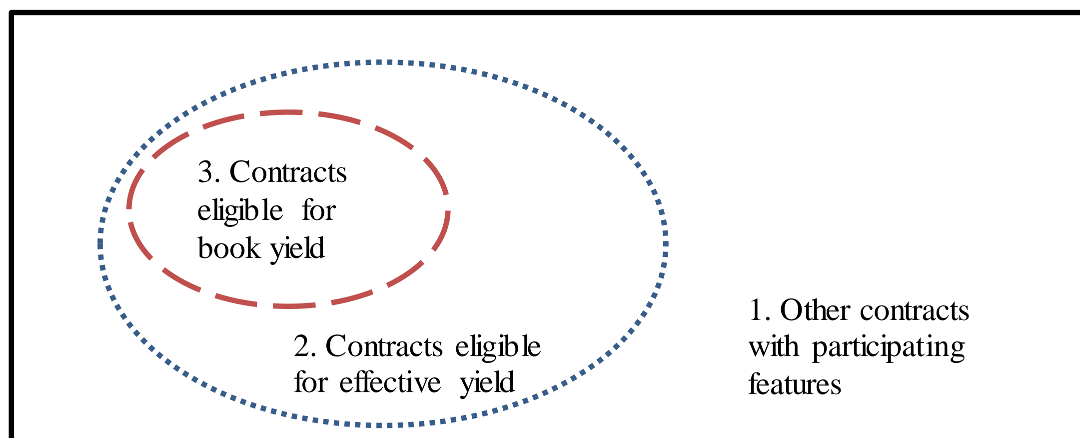
4. Consequently, an entity would determine the interest expense in profit or loss using an effective yield approach for **all** contracts in which the expected cash flows of the contracts that vary with returns on underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contracts.

5. The staff reminds the IASB that the recommendations 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.

Which OCI approach, or approaches, should apply for contracts with participating features?

6. In Agenda Paper 5C *Use of OCI for contracts with participating features*, the staff summarised the potential applicability of the book yield and effective yield approaches for determining interest expense in profit or loss using the following diagram. The staff's proposed versions of the book yield and effective yield approaches were described in Agenda Paper 5A *Book yield and effective yield approaches to presenting interest expense in profit or loss* and are illustrated in , Agenda Paper 5B *Illustrative examples of book yield and effective yield approaches*.

Contracts with participating features



7. Agenda Paper 5C recommended approaches to the use of other comprehensive income (OCI) in sectors 1 and 2 of the diagram as follows:

   (a) **Sector 1**, ie contracts in which a substantial proportion of total benefits to the policyholder over the life of the contracts *do not vary* with investment returns on underlying items – the staff recommended the same approach as that applied to contracts without participating features, ie rates locked-in at initial recognition for the presentation of interest expense.

   (b) **Sector 2**, ie contracts in which a substantial proportion of total benefits to the policyholder over the life of the contracts *vary* with investment returns on underlying items but where:

      (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.

   – the staff recommended an effective yield approach for the presentation of interest expense. As a result of this recommendation, if the IASB accepts the staff recommendations in Agenda Paper 5C, some

contracts would be accounted for using the effective yield approach, regardless of the IASB's decisions in this paper.

8. In this paper we consider whether the book yield or effective yield approach should be applied to contracts in Sector 3, ie those 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 the accounting mismatches in profit or loss between the insurance contract and the underlying items.

9. Accordingly, the following sections compare and contrast the relative merits of the book yield and effective yield approaches for such contracts in relation to:
   (a) reducing accounting mismatches (paragraphs 11 to 13); and
   (b) complexity (paragraphs 14 to 23).

10. The staff recommend in Agenda Paper 5C that 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. However, the staff propose that the IASB should mandate the approach taken to present the effects of changes in discount rates in OCI when the entity chooses to present the effects of discount rate changes in OCI. The staff believe that a further choice on the mechanics of how to apply the OCI election (ie allowing both the book yield and effective yield approaches) and would be confusing for users of the financial statements.

Reducing accounting mismatches

11. In situations where the crediting to the policyholders follows the gains and losses of underlying items arising in profit or loss, both the book yield and the effective yield approaches may produce similar results.

12. However, the book yield reduces accounting mismatches, in comparison with effective yield, when there are timing differences between the period when gains and losses arising from the underlying items are recognised in profit or loss and the periods when amounts are credited to the policyholder. This is the case, for example:

    (a) When the underlying items include a combination of items accounted for at cost and items accounted for at fair value through profit or loss and amounts are credited to the policyholder on a 'cost' basis. This is because the book yield approach would reflect the profit and loss effect from the combination of underlying items. This is illustrated in the examples Scenarios 2 and 3 Agenda Paper 5B.

    (b) When specified underlying items are accounted for at cost and gains or losses are recognised on their sale in profit or loss and those gains and losses are not immediately credited to the policyholder. This is because the book yield approach would result in a corresponding amount recognised in profit or loss for the liability. This is illustrated in the example Scenario 4 in Agenda Paper 5B.

13. However, as described in paragraph 18 of Agenda Paper 5C and paragraph 36 or Agenda Paper 5A, the staff proposes that the book yield approach should be applied only when doing so would reduce accounting mismatch. This means that the book yield might not be capable of application for some types of underlying items accounted for at cost or FVOCI in some circumstances as discussed in paragraph 23 of Agenda Paper 5A. In those cases, the staff note that an entity could address accounting mismatches by choosing to present the effects of discount rate changes for the liability in profit or loss and to elect to account for the underlying items at fair value through profit of loss (FVPL). However, many constituents believe that they should not be compelled to measure items as FVPL that are eligible for FVOCI or amortised cost.

Complexity

Calculation

14. As can be seen from Agenda Papers 5A and 5B, both the book yield and effective yield approaches require complex calculations and record-keeping. It is difficult to assess the relative complexity of those two approaches, as it will depend, amongst other things, on the type of product and the processes already existing.

15. One question that arises is whether the effective yield or book yield approaches are less complex that the proposals in the 2013 ED. Feedback indicated that applying the proposals in the 2013 ED for the determination of interest expense would require an entity to split the cash flows of the contract and apply appropriate discount rates to each set of cash flows. Neither the book yield nor the effective yield approaches would require entities to split the cash flows, and some suggest that these approaches would therefore be significantly less complex to apply.

16. As for measurement, the staff notes that there may be different ways to achieve the objectives of the book yield and effective yield approaches. One concern raised by a Board member at a previous meeting is that those different ways might result in different amounts of interest expense presented in profit or loss. However, the staff thinks that:

    (a) For the book yield approach, the objective is to reduce accounting mismatches between the presentation of interest expense in profit or loss and interest income on the underlying items when there is an economic match between the underlying items and the insurance liability. Although there may be different ways to achieve this objective by discounting cash flows using discount rates that do not, in themselves, reflect the characteristics of the liability (eg using risk-neutral modelling which would discount risk-adjusted cash flows using risk-free rates to measure the liability), the entity would need to make appropriate adjustments to ensure that the interest expense in profit or loss was determined in a way that is consistent with the basis for reporting the gains and losses from the underlying items in profit or loss.

(b) For the effective yield approach, interest expense is determined by reference to the rate or rates that exactly discounts estimates of expected future cash flows to the carrying amount of the liability determined on an amortised cost basis at the last reset date. If an entity were to adjust the expected cash flows used for determining effective yield, it would need to make appropriate adjustments to ensure that the interest expense reflects the amounts credited to the policyholder and the expected future cash flows.

17. The staff notes that the need for adjustments might introduce some complexity. However, the staff understands that proponents of each approach believe that the approach is operational. Furthermore, the staff notes that the use of OCI to present the effects of changes in discount rate would be the subject of an accounting policy choice. Therefore, entities will be able to assess whether the costs of applying the approach the board selects for determining interest expense and OCI would outweigh the benefits.

Understanding the information

18. Conceptually the discount rate derived from the book yield approach for the presentation of interest expense is different from the discount rate used for the measurement of the liability on the balance sheet. As discussed in paragraphs 26-35 and 36(c) of Agenda Paper 5A, the staff propose that an entity should determine the book yield at inception of the contract using the current discount rate used to measure the liability on the balance sheet. However, this approach would lead to a 'catch up adjustment' in subsequent periods that would be difficult to explain except by reference to the mechanics.

19. Those that support the book yield approach believe that such gains and losses reported in profit or loss are not likely to be significant. However, staff thinks that this is not always the case. For example, there could be significant gains or losses when the entity issues a new portfolio of contracts of participating features and where there are significant timing differences between the receipt of premiums and the investments in the underlying items.

20. The catch up adjustment does not arise for the effective yield approach.

In the standard as a whole

21. Contracts eligible for the book yield approach are a subset of those eligible for the effective yield approach (as discussed in Agenda Paper 5C). The staff proposed in Agenda Paper 5C that entities should in any case apply the effective yield approach to contracts for which a substantial proportion of total benefits to the policyholder over the life of the contracts *vary* with investment returns on underlying items but which are not eligible for a book yield approach. As a result, one disadvantage of introducing a book yield approach is that it adds more complexity to the proposed requirements as a whole because it would introduce a third method of determining interest expense. If effective yield were applied to all contracts within its scope (ie the effective yield, rather than the book yield approach, were to be applied to contracts eligible for book yield), entities would determine interest expense as follows:

    (a) For contracts in which cash flows that vary with returns on underlying items are **not** a substantial proportion of total benefits to policyholders over the life of the contract, the interest expense would be determined using the rate locked-in at inception. The mechanics would be the same as those required for contracts without any participating features for which an entity choses to present the effects of discount rate changes in OCI.

    (b) For contracts 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, the interest expense would be determined using the effective yield approach.

22. In contrast, if the book yield approach were to be applied to eligible contracts, entities would determine interest expense as follows:

    (a) For contracts in which cash flows that vary with returns on underlying items are **not** a substantial proportion of total benefits to policyholders over the life of the contract, the interest expense would be determined using the rate locked-in at inception.

    (b) For contracts 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 outside the scope of book yield, the interest expense would be determined using the effective yield approach. (The contracts to which the book yield approach is restricted to is set out in paragraph 1).

(c) For contracts 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, and which meet the scope criteria of book yield, the interest expense would be determined using the book yield approach.

23. The greater the number of approaches for determining interest expense in profit or loss, the greater the complexity for users. This is because users would need to understand the information produced by the different variations, and to understand which contracts are accounted for using the different variations.

Conclusions

24. Both the book yield and the effective yield approaches have shortcomings in the usefulness of information portrayed. For example, the book yield approach would increase overall complexity by introducing an additional mechanism for presenting interest expense in addition to the effective yield approach, and it has the catch up adjustment on day two. Effective yield is not as closely linked to how the returns from underlying items are reported in IFRS as book yield. As a result, effective yield may not reduce accounting mismatches in profit or loss to the same degree as book yield when there are differences in timing between the amounts credited to the policyholder and the gains and losses recognised in profit or loss from the underlying items.

25. The catch up adjustment in the book yield approach arises from the fundamental feature of applying a different discount rate for the presentation of interest expense than the discount rate used for measurement. Consequently, there is no way of addressing this issue within the book yield approach.

26. Some are attracted to the effective yield approach because it does not have the catch up adjustment. However, effective yield has shortcomings in that it results in accounting mismatches when there is a mix of accounting basis for the

underlying items, or when assets held at cost or FVOCI are realised and those gains and losses are not reflected in the amounts credited to the policyholder in the same period. As discussed in Agenda Paper 5A paragraphs 61-65, those shortcomings could perhaps be overcome, but the staff did not think that there would be sufficient benefit in doing so.

27. Both the book yield and effective yield approaches require complex calculations and record keeping. It is difficult to assess the relative complexity of those two approaches. However, because an effective yield approach would be required for contracts for which a substantial proportion of total benefits to the policyholder over the life of the contracts *vary* with investment returns on underlying items but which are not eligible for a book yield approach, introducing a book yield approach would increase the complexity of the standard as a whole.

28. On balance, the staff recommend that that if entities choose to present the effect of changes in discount rates in other comprehensive income for contracts with participating features, interest expense presented in profit or loss should be determined using an effective yield approach for contracts in which a substantial proportion of total benefits to the policyholder over the life of the contracts vary with investment returns on underlying items – including contracts that might otherwise be eligible for a book yield approach.

Question 1: Should a book yield approach be available if certain criteria are met?
When an entity presents the effect of changes in discount rates in other comprehensive income, does the board agree **not** to permit the use of the book yield approach for the presentation of interest expense?

29. Consequently, an entity would determine the interest expense in profit or loss using an effective yield approach for **all** contracts in which the expected cash flows of the contracts that vary with returns on underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contracts. That is for contracts in both Sectors 2 and 3 in the diagram in paragraph 6.