STAFF PAPER

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IASB Meeting

Project	**Insurance contracts**		
Paper topic	Adaptations for insurance contracts that provide policyholders with investment returns: proposed accounting for CSM and OCI		
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Purpose of this paper

1. Agenda Paper 2A *Adaptations for insurance contracts that provide policyholders with investment returns: Background and scope* described circumstances in which an insurance contract with cash flows that vary with underlying items could be viewed as creating an obligation to pay to the policyholder an amount equal to the underlying items less a variable fee for service.

2. This paper describes (in paragraphs 8-23) the consequences for the measurement of an insurance contract when the insurance contract provides policyholders with returns that vary with underlying items, both when:

   (a) when the insurance contract *can* be viewed as creating an obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service; and

   (b) when the insurance contract *cannot* be viewed as creating an obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service.

3. In addition, this paper considers how an entity could disaggregate interest expense for participating contracts into an amount presented in profit or loss and an amount that is presented in other comprehensive income (OCI), if the IASB were to confirm that there should be an OCI approach for contracts with participation features (paragraphs 26-46).

4. Finally, this paper considers the need for an entity to reassess whether an entity can continue to apply an approach which assumes that the obligation is to pay to policyholders an amount that is equal to the value of underlying items remains valid after initial recognition (paragraphs 47-53).

5. Appendix A compares, at a high level, the staff proposals for the measurement of the contractual service margin after initial recognition, and for the current period book yield approach with the proposals from European CFO Forum approach discussed in November 2014.

6. Appendix B illustrates how the scope the staff propose in Agenda Paper 2A and the accounting described in this paper would apply to contracts with different features. Appendix C describes what would be recognised in profit or loss and OCI, and what would adjust the contractual service margin in each case.

7. The staff is not asking for decisions at this meeting

Measurement

8. As with all insurance contracts, an entity would measure an insurance contract using a current value approach that represents an insurance contract as comprising both:

   (a) an obligation to pay net future cash outflows, represented by the fulfilment cash flows; and

   (b) an obligation to provide insurance coverage over the coverage period, represented by the contractual service margin (CSM).

9. The measurement of these components is discussed below.

Fulfilment cash flows

10. The measurement of the fulfilment cash flows described in Agenda Paper 2A would not need to be modified for contracts with cash flows that vary with the returns on underlying items, or in an approach that views the entity's obligation as being to pay to policyholders an amount equal to the value of the underlying items, less a variable fee for service. This is because the fulfilment cash flows

already incorporate all the available information about the cash flows that are expected to arise from the contract, including the cash flows that are equal to the value of the underlying items. Thus, the staff note that for contracts with cash flows that vary with the returns on underlying items:

(a) The cash flows that relate directly to the fulfilment of insurance contracts include payments that arise from existing contracts that provide policyholders with a share in the returns on underlying items, regardless of whether those payments are made to current or future policyholders[1];

(b) To the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depend wholly or partly on the returns on underlying items, the characteristics of the liability reflect that dependence. The discount rate used to measure those cash flows would therefore reflect the extent of that dependence.[2]

(c) The risk adjustment reflects all risks associated with the insurance contract, other than those reflected through the use of market consistent inputs.[3] It does not reflect the risks that do not arise from the insurance contract, such as investment risk related to assets that an entity holds (except when that investment risk affects the amounts payable to policyholder), asset-liability mismatch risk or general operational risk that relates to future transactions.[4]

Contractual service margin at initial recognition

11. As with all insurance contracts, the contractual service margin at initial recognition is determined at an amount that is equal and opposite to the sum of the amount of the fulfilment cash flows for the insurance contact at initial recognition

[1] Paragraph B66(k) of the 2013 Exposure Draft *Insurance Contracts* (the 2013 ED).

[2] Paragraph 26(a) of the 2013 ED.

[3] B44 of the ED states: "Estimates of market variables shall be consistent with observable market prices at the end of the reporting period. An entity shall not substitute its own estimates for observed market prices except as described in paragraph 79 of IFRS 13. If market variables need to be estimates […] they shall be as consistent as possible with observable market variables."

[4] Paragraph B78 of the 2013 ED.

and any pre-coverage cash flows. If the insurance contract is viewed as creating an obligation to pay to policyholders an amount equal to the value of underlying items less a variable fee for service, the fee for service that the entity expects at initial recognition would be equal to the contractual service margin at initial recognition.

Example at initial recognition

12. The discussion in this paper is illustrated using a simple example, which is based on the example in Agenda Paper 2A, but incorporates a participation feature, rather than an expected claim. The example uses the following assumptions:

Assumptions

A policyholder pays a premium of CU1,000 for a 5-year insurance contract with a participation feature. In exchange the entity promises to pay the policyholder:

- A death benefit in the event that the policyholder dies. As a simplifying assumption, the probability of the policyholder's death during the coverage period is negligible.
- 90% of the returns the entity will earn by investing the CU1,000 premium.

The entity immediately invests the premium received. For simplicity, the entity expects to sell the investment and receive CU1,276 at the end of five years. This is equivalent to a 5% return on the investment per year. As a result, the expected cash outflow to the policyholder at the end of 5 years is CU1,249 (comprising CU1,000 plus 90% of CU276). The difference of CU27 is the amount of the variable fee that the entity expects to earn from the contract at inception.

To simplify the example, the risk adjustment is assumed to be zero.

Initial recognition

At initial recognition, the expected cash flows comprise an inflow of CU1,000 at inception and an outflow of CU1,249 at the end of year 5. The present value of the cash inflow is CU1,000 and the present value of the cash outflow is $CU1,249/1.05^5 = CU979$.

Thus, the fulfilment cash flows immediately before the premium is received are

CU1,000-CU979= CU21, and this means that the contractual service margin at inception is CU21 to eliminate the gain at inception.

When the entity receives the premium of CU1,000 at initial recognition, the fulfilment cash flows are CU(979). The premium of CU1,000 that is received at initial recognition is available to invest in assets on behalf of the policyholder (the underlying items).

(The fulfilment cash flows can also be analysed as an amount equal to the underlying items less the expected present value of the fee, ie CU1,000-CU21 = CU979.)

The entity makes the following journal entries at initial recognition:

Dr Cash (Premiums received)	1,000		
Cr insurance contract (fulfilment cash flows)			979
Cr insurance contract (CSM)			21

In addition, the entity makes the following journal entry when the premium of CU1,000 is invested:

Dr investment	1,000		
Cr cash			1,000

13. Thus, the fulfilment cash flows and the contractual service margin at initial recognition do not require adaptations when the contract provides cash flows that vary with the returns on underlying items, or when the contract is viewed as creating the obligation to pay to policyholders an amount equal to the value of the underlying items, less a variable fee for service. However, viewing the contract as creating the obligation to pay to policyholders an amount equal to the value of the underlying items would create differences for the contractual service margin at subsequent measurement (see paragraphs 14-23).

Contractual service margin subsequent to initial recognition

14. The presence of cash flows that vary with underlying items does not itself create the need for adaptations to the determination of the contractual service margin subsequent to initial recognition. Changes in the estimates of those cash flows arise from changes in financial estimates, and would be recognised in profit or

loss, or other comprehensive income in the period, according to the accounting policy chosen. Changes in the estimates of the underlying items would be accounted for in accordance with applicable IFRSs.

15. However, when the insurance contract liability is viewed as being an obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service, then:

    (a) Changes in the estimate of the obligation to pay to the policyholder an amount equal to the value of the underlying items should be accounted for in a way that reflects changes in the value of the underlying items.

    (b) Changes in the estimate of the variable fee for future services should be accounted for in a way consistent with the changes in estimate relating to future service. Accordingly, such changes in estimates would be adjusted in the contractual service margin so that they would be recognised in future periods, rather than in the period in which they occur.

16. At inception, the variable fee for service comprises the entity's share of the returns on underlying items less the expected outflows that relate to any non-investment cash flows or that are used to pay for guarantees. As a consequence, this approach would mean that changes in the value of any options or guarantees in the contract would be adjusted against the contractual service margin.

Example at subsequent measurement

Subsequent measurement when the obligation is to pay an amount equal to the value of the underlying items less a variable fee for service

Continuing the example in paragraph 12, assume that at the end of Year 1 the value of the investment increases to CU1,200 and the entity now expects the expected cash flow from the investment at the end of Year 5 will be CU1,376. Assume that the investment is measured at fair value through profit or loss and that the entity therefore recognises the gain of CU200 in profit or loss.

The entity would remeasure its obligation to pay an amount equal to the value of the underlying items at CU1,200 (rather than CU1,000).

The expected fee for service, which is 10% of the share of asset returns would be 10% of CU1,376-CU1,000=CU38 (rather than CU21). The present value of the entity's expected fee of CU38 discounted using the updated asset rate of 3.481%[5] will equal CU34.[6] This is the new estimate of the contractual service margin.

The new estimate of the fulfilment cash flows would be:

Value of underlying items – present value of expected fee
=CU1,200-CU34 = CU1,166

Thus the change in the value of the underlying items of CU1,200-CU1,000=CU200, the changes in the fulfilment cash flows of CU1,166-CU979=CU187 and the change in the fee of CU34-CU21=CU13 would be accounted for as follows:

Dr investment 200

Cr P&L 200

To record the change in fair value of the underlying items

Dr P&L 200

Cr insurance contract (fulfilment cash flows) 200

To record the change in fulfilment cash flows representing the change in the obligation to pay an amount equal to the value of the underlying items

Dr insurance contract (fulfilment cash flows) 13

Cr insurance contract (contractual service margin) 13

To reflect the estimated additional fee the policyholder will pay

There would be no net change in profit or loss in the period. Instead, the change would be recognised as the contractual service margin is allocated over the contract term. Thus, the financial statement would depict the entity as receiving the increase in the expected fee in the periods that the related service is provided.

[5] For the purpose of this example, the updated asset rate has been assumed to be the yield from the fair value of CU1,200 to the expected cash flow of CU1,376.

[6] The net change in the contractual service margin of CU1 is the equivalent of the increase in value of the investment (CU10) less the increase in expected cash flows to the policyholder (CU9).

17. In contrast, if the arrangement was not viewed as a promise by the entity to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service, then:

    (a) The change in value of the underlying items is recognised in profit or loss, ie

    Dr investment 200
        Cr P&L 200

    To record the change in fair value of the underlying items

    (b) The revised estimate of the cash outflow at the end of Year 5 is CU1,000+ 90% of CU(1,376-1,000)=CU1,338. The present value of this amount, determined using the new current liability rate of 3.481% is CU1,166. The entity would remeasure the fulfilment cash flows from CU979 to CU1,166 (ie a difference of CU187) as follows:

    Dr P&L 187
        Cr insurance contract (fulfilment cash flows) 187

    To record the change in fulfilment cash flows

    (c) There is no adjustment to the contractual service margin.

    Therefore, there would be a net credit in profit or loss of CU13, which would depict the entity as having received an increase in its economic interest in the underlying items in that period.

Rate used to determine the present value of the adjustments to the CSM and the accretion of interest on the CSM

18. The measurement of the contractual service margin subsequent to initial recognition is also affected by the rate that is used to determine the present value of the adjustments to the contractual service margin, and any interest accreted on the contractual service margin (which adjusts the contractual service margin for the effects of the time value of money).

19. When amounts that adjust the contractual service margin reflect the current period's estimate of the expected variable fee for service, those amounts incorporate the current period's estimates of asset returns. This means that the adjustment to the contractual service margin, in effect, is determined using the

discount rate at the date of the change in estimate. Thus, for contracts in which the obligation is to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service, the discount rates used to determine the present value of the adjustment to the contractual service margin would be current discount rates.

20. Similarly, because the entity's obligation to pay to the policyholders an amount equal to the value of the underlying items reflects the current values of the underlying items, the measurement of the obligation already incorporates implicitly accretion of interest on the contractual service margin using current rates.

21. In contrast, the IASB has previously concluded that the discount rates used to determine the present value of changes in estimates that adjust the contractual service margin for contracts without participation features are the locked-in rates. The locked-in rates are also used to accrete interest on the contractual service margin for those contracts.

22. This difference reflects that, when the entity has an obligation for which the amount depends on the value of the underlying items, or which varies with asset returns, that obligation must necessarily reflect the current discount rate. That is not the case for contracts when the obligation does not depend on the value of the underlying items.

23. The staff note that, for contracts without participation features, some interested parties have suggested that the IASB should require a current discount rate for determining the present value of the amounts that adjust the contractual service margin, and for determining the accretion of interest. The staff do not consider that suggestion in this paper.

Summary

24. When the entity's obligation is to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service, the:

    (a) No adaptations are needed to the general approach for the fulfilment cash flows (see paragraph 10) or the contractual service margin at initial recognition (see paragraphs 11-13)

(b) the contractual service margin after initial recognition would be adjusted for changes in:

(i) the expected net variable fee for service, and

(ii) changes in the expected present value of the cost of guarantees. (see paragraphs 14-16).

(c) the rates used to determine the present value of adjustments to the contractual service margin, and the rates used to accrete interest on the contractual service margin are current rates (see paragraph 21-23).

25. When the entity's obligation cannot be viewed as the obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service, the:

(a) no adaptations are needed to the general approach for the fulfilment cash flows (see paragraph 10), the contractual service margin at initial recognition (see paragraphs 11-13) or the contractual service margin after initial recognition (see paragraphs 17)

(b) the rates used to determine the present value of adjustments to the contractual service margin, and the rates used to accrete interest on the contractual service margin are current rates (see paragraphs 21-23).

Question 1: contractual service margin

Do you have any questions or comments on the measurement of the contractual service margin in a contract with cash flows that vary with underlying items:

(a) when the entity's obligation is viewed as an obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service; or

(b) when the entity's obligation is *not* viewed as an obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service?

Interest expense in the statement of comprehensive income

Contracts that do not have cash flows that vary with the returns on underlying items

26. For non-participating contracts, the IASB has decided that entities could choose an accounting policy that would report interest expense in profit or loss determined using a locked-in discount rate. The reason for this decision was to permit entities to adopt an accounting policy that would reduce the general accounting mismatch in profit or loss between interest expense on insurance contract liabilities and the related investment income from assets that report amortised cost information in profit or loss (ie assets measured at amortised cost or FVOCI).

27. This approach reduces, rather than eliminates, the accounting mismatch between insurance contract liabilities and assets an entity holds. For example, accounting mismatches would remain if an entity were to sell an asset at amortised cost or FVOCI and realise a gain in profit or loss for the assets. A loss to offset that gain would not be reflected in the interest expense in the insurance contract. However, in a non-participating contract, there is no dependence of the cash flows of the contract on underlying items, and there are no assets specifically identified as backing insurance contracts. This means that achieving a greater reduction in the general accounting mismatch between assets and liabilities would not be possible.

Contracts where the cash flows vary with the returns on underlying items

28. As noted in paragraph 26, the IASB decided that, for non-participating contracts, an entity may choose an accounting policy to present all interest expense in profit or loss, or to present part of the interest expense in profit or loss and part in OCI. The IASB has yet to consider whether to permit or require the OCI approach for contracts where the cash flows vary with the returns on underlying items. The following section discusses the approaches that might be used if the IASB were to conclude that an OCI approach for contracts with participation features should be permitted or required, as follows:

    (a) Effective yield approach (paragraphs 29-35); and

(b) Current period book yield approach (paragraphs 36-46).

Effective yield approach

29. The 2013 ED proposed that, when some of the cash flows of an insurance contract vary with returns on underlying items, the interest expense recognised in profit or loss should be calculated as follows:

(a) the discount rates applied to cash flows that do not vary with underlying items are locked-in at inception; and

(b) the discount rates applied to cash flows that vary with underlying items are reset every time there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders.

30. The reason for resetting the discount rate when there are changes in estimates of investment returns that result in changes in the amount paid to the policyholder is that doing so would be consistent with:

(a) the entity's expectation that it will pass on to policyholders the effects of changes in market variables—including interest rates. For example, if market interest rates rise, an entity would expect to receive higher investment income from underlying items in the future and pay higher amounts to policyholders. As a result, discounting higher expected cash outflows using locked-in (ie lower) discount rates would increase the present value of liabilities and not fairly reflect the economic effects of such a change in market variables.

(b) the accounting for floating rate debt instruments that are not accounted for at fair value through profit and loss (for example, at FVOCI). For floating rate debt instruments accounted for at amortised cost, the locked-in discount rate used to present interest expense is reset upon changes in interest rates. The outcome would be similar to that intended by the use of a locked-in yield curve when there are no cash flows that vary with underlying items. However, one consequence of resetting the discount rate when there are changes in estimates of investment returns that result in changes in the amount paid to the policyholder is that entities would need to split the cash flows into those

that vary, and those that do not vary, with underlying items and apply different discount rates to those two types of cash flow.

31. During its 2014 education sessions, the IASB noted the feedback about the proposals in the 2013 ED, in particular that:

    (a) It would be difficult for entities to split the cash flows, and apply different discount rates to different sets of cash flows to determine the interest expense to be recognized in profit or loss, because most entities do not split the cash flows in way prescribed by the IASB in the 2013 ED.

    (b) Some did not think the costs of applying different discount rates updated at different times to different sets of cash flows would be justified by the benefits of doing so, particularly because splitting the cash flows is not needed for measurement.

32. At its July 2014 meeting, the IASB agreed that it should try to avoid imposing requirements that result in the need to split the cash flows with different characteristics within a contract only for the purpose of presentation. Therefore, the IASB directed the staff to consider approaches for presentation of interest expense that would require an entity to apply the same discount rate to all the cash flows of the contract.

33. However, the IASB also noted that, conceptually, it is appropriate to apply reset discount rates only to cash flows that vary with underlying items. Locked-in discount rates should, conceptually, be applied to cash flows that do not vary with underlying items. Therefore, an approach that applied updated discount rates to all the cash flows of the contract would need to be restricted to where cash flows that vary with the returns on underlying items are the predominant component in the contract. Accordingly, in July 2014, the staff proposed that:

    (a) An entity should use an effective yield approach to determine interest expense only when the cash flows in the contract that vary with the returns on underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contracts. The effective yield approach updates the locked-in rate to reflect changes in underlying items for all the cash flows in the contract.

(b) An entity should use discount rates locked-in at initial recognition to determine interest expense in profit or loss when the cash flows in the contract that vary with the returns on underlying items are *not* a substantial proportion of the total benefits to the policyholder over the life of the contract.

The difference between the interest expense recognised in profit or loss and the interest expense consistent with the balance sheet measurement would be recognized in OCI.

Modifications to the effective yield approach proposed in the 2013 ED

34. During its 2014 education sessions, the staff proposed that the IASB explore an effective yield approach in which the discount rate used for the presentation of interest expense in profit or loss should be determined using a form of the effective interest method which is used in IFRS 9 *Financial Instruments* (IFRS 9). The effective interest method in IFRS 9 is used to calculate the amortised cost of financial instruments and to allocate the interest income or interest expense on those financial instruments to profit or loss. That approach would modify the proposals in the 2013 ED by determining the interest expense in profit or loss using a single discount rate that exactly reverses out any amounts recognised in OCI over the life of the contract, rather than by using a yield curve as proposed in the 2013 ED. The modified approach would average the differences between the discount rates for each period/tenor across the yield curve and was intended to further reduce the accounting mismatch in profit or loss when the underlying items are accounted for at cost, in particular amortised cost. The effective interest method for financial instruments results in interest income determined in a similar way.

35. In September 2014[7], the IASB considered both a level yield and a projected crediting variation for the effective yield approach. The staff also considered whether there should be modifications to the effective yield approach to address the accounting mismatches that might arise between interest expense and

[7] See paragraphs 38-67 of agenda paper 2A for the September 2014 IASB meeting.

investment income when an effective yield approach is applied in circumstances where:

(a) The underlying items are a mix of assets measured at FVPL and cost; and

(b) The underlying items measured at cost are sold and a realised gain or loss is presented in profit or loss – without a corresponding change in amounts credited to policyholders.

If the IASB decides to adopt an effective yield approach for determining interest expense in profit or loss, the staff would consider at a future meeting which version of the effective yield approach should be used.

Current period book yield approach

36. When an entity's obligation is to pay to policyholders an amount equal to the value of the underlying items less a variable fee for service, and the entity holds the underlying items, there is potential for a complete reduction in accounting mismatch because there is an exact match between the items underlying the obligation, and the obligation itself.

37. In particular, the staff observe that, if the entity is obliged to pay to the policyholder an amount equal to the value of any returns from underlying items, there should be no net investment return arising from the underlying items in the financial statements of the entity. In other words, the interest expense on the promise to pay an amount equal to the value of the underlying items should exactly match the investment income that arises from the underlying items. That observation forms the basis of an approach that could eliminate accounting mismatches in profit or loss between the underlying items and the obligation to pay to the policyholder an amount equal to the value of the underlying items, without a significant degree of operational complexity.

38. Accordingly, the staff propose that, where the entity's obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service, and the entity holds the underlying items, the entity should determine the interest expense in profit or loss on the insurance contract liability as equal and opposite in amount to the investment income on the underlying items

that is reported in profit or loss. Any difference between the interest expense reported in profit or loss and the interest expense determined on a current basis would be reported in OCI. This would ensure that the accounting basis for the underlying items and the accounting basis for the obligation to pay to the policyholder an amount equal to the value of the underlying items results in equivalent and opposite effects in profit or loss.

39. The staff observe that under this 'current period book yield approach':

    (a) The interest expense in profit or loss for the obligation to pay to the policyholder an amount equal to the value of the underlying items would always match the investment income on those same underlying items, regardless of the accounting requirements for the underlying items under IFRS. Any difference between the interest expense reported in profit or loss and the interest expense determined using a current rate would be recognised in OCI.

    (b) Accounting mismatches may still arise in equity. This would be particularly the case if the underlying items included amounts that were not measured at fair value, for example financial assets at amortised cost or investment property at cost.

    (c) The approach eliminates the need to bifurcate cash flows for the purposes of determining interest expense.

40. The staff believe that this approach would be consistent with the proposals in the forthcoming *Conceptual Framework* ED for the use of OCI. That ED:

    (a) includes a presumption that all items of income or expense should be reported in profit or loss; and

    (b) states that sometimes excluding from the statement of profit or loss some income or expenses that result from a *change in a current measure* of an asset or liability may enhance the relevance of the information in that statement. When this is the case, that income or expense is recognised elsewhere in the statement(s) of performance, ie in OCI.

41. Under the proposed current period book yield approach, the amount that is recognised in OCI in the period is a component of the remeasurement of the insurance contract. Furthermore, because the economic effect of the transaction is that any return from the underlying assets should be offset by an increase in the obligation due to the policyholders, there is no economic mismatch. Arguably then, presenting an accounting mismatch would decrease the relevance of profit or loss for the period, and this outcome is avoided by the staff's approach. Accordingly, the staff believe that the amounts presented in OCI would be consistent with the proposals in the forthcoming *Conceptual Framework* ED.

42. At the September 2014 meeting the staff discussed a current portfolio book yield approach with similar objectives to the current period book yield, ie to divide interest expense in an amount recognised in profit or loss and an amount recognised in OCI is to reduce accounting mismatch in profit or loss,. The IASB indicated that the use of the current portfolio book yield approach might introduce unacceptable complexity in the Standard as a whole, given that there is also a need to specify other approaches for determining interest expense when the contract does not qualify for the book yield approach, thus add the complexity of needing to specify both a book yield approach and an effective yield approach.. However, the staff believe that a current period book yield approach is justified on balance, because of the more complete reduction in accounting mismatches it provides compared to effective yield approach, when the current period book yield approach is applied to the appropriate contracts. That conclusion differs from the staff's conclusion in September 2014, largely because the proposals in this paper for a current period book yield significantly reduce the operational complexity compared to the current portfolio book yield approach considered in September 2014.

When the current period book yield approach could apply

43. The current period book yield approach assumes that all mismatches between the interest expense reported in profit or loss for the insurance contract and the investment income on underlying items are accounting mismatches and not economic mismatches. Accordingly, the staff believe that the current period book yield approach should apply only when there is no possibility of economic mismatch.

44. That would be the case when there is a match between the entity's obligation to the policyholder and items that the entity holds.

45. Accordingly, the staff believe that the current period book yield approach proposed in this paper should apply when:

    (a) the entity's obligation is to pay to the policyholder an amount equal to the value of the underlying items less the variable fee for service, ie when the criteria for unlocking the contractual service margin are met; and

    (b) an entity holds the underlying items, either through choice or because it is required to.

46. Accordingly, the staff propose that the current period book yield approach should be applied in more restricted circumstances than the scope for unlocking the contractual service margin for the entity's share of asset returns.

Question 2: Interest expense
Do you have any questions or comments on the application and scope of the effective yield approach? (paragraphs 29-35) Do you have any questions about the application and scope of the current period book yield approach? (paragraphs 36-46)

Reassessment of eligibility for accounting approaches

47. The characteristics of contracts may vary over time. Reassessment comes into question when there is a change in circumstances which means that a contract that previously met a criteria no longer does so, or vice versa. Thus:

    (a) The requirement that there is a clearly defined pool of underlying items should not drive a need for reassessment. Such a pool would need to be specified in the contractual terms, and is unlikely to change with circumstances.

    (b) There could be a change in the extent to which the policyholder expected that a substantial proportion of cash flows from the contract to vary with changes in underlying items. This could be, for example,

because a guarantee is expected to govern the cash flows of the contract more than originally anticipated.

(c) There could be a change in the extent to which the entity expects the policyholder to receive a substantial share of returns from underlying items. This could be the case, eg when the share the policyholder expects to retain is largely at the discretion of the entity, and the entity changes its expectation of the discretion it plans to exercise.

(d) The criteria that an entity must hold the underlying items to apply a current period book yield approach applies throughout the period the current period book yield approach is applied. Thus there could be a change in whether the conditions for the current period book yield approach are met when the entity chooses no longer to hold underlying items that it originally held, or chooses to hold underlying items after not previously doing so.

48. The staff note that the 2013 ED similarly had situations in which a change in circumstances after the inception of the contract could result in different accounting than would have been applied had the change in circumstances been known when the contract was initially recognised. For example:

(a) The new insurance contracts Standard would apply to contracts that meet the definition of an insurance contract, ie contracts that transfer significant insurance risk from one party to another. However, for some contracts, the insurance risk could expire during the contract term. The entity would continue to apply the new insurance contracts Standard to such contracts, even after all the insurance risk expired.

(b) The new insurance contracts Standard will permit entities a simplified approach for measuring the liability for remaining coverage (ie the premium allocation approach), provided specified criteria are met. However, if an entity later found that the criteria for the simplified approach were not met, for example, because the results of applying the premium allocation approach later prove not to be an approximation to

the results of applying the general approach, it would continue to apply the simplified approach to those contracts.[8]

49. The 2013 ED also proposed that if the change in circumstance arose as a result of a contract modification, rather than as a result of developments that contradicted original expectations, then an entity would derecognise the original insurance contract and recognise a new contract. The eligibility criteria in each case would be applied to the new contract recognised.

50. The staff propose that the same approach be applied to contracts for which the accounting depends on whether a substantial proportion of cash flows from the contract to vary with changes in underlying items, or the entity expects the policyholder to receive a substantial share of returns from underlying items. Thus, there would be no requirement for an entity to reassess whether these criteria apply after initial recognition. Those criteria are based on the entity's expectations, and developments that contradict the original expectations should not result in a change to accounting approach, consistent with the approach for determining the presence of significant insurance risk or eligibility for the premium allocation approach.

51. Although not requiring reassessment as proposed in paragraph 50 could result in reduced comparability between contracts that originally met the qualifying criteria and those that did not, the staff note that the IASB previously concluded that requiring the continuous monitoring of whether a contract meets the definition of an insurance contract over the life of the contract would be too onerous.[9] In other words, the costs of requiring such monitoring would not outweigh the benefits of doing do. The staff think that this applies equally to determining whether a contract should be viewed as creating the obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee.

52. However, the staff do not think that this conclusion holds for the requirement that an entity hold the underlying items for the purpose of applying a current period book yield approach. Because the justification for the current period book yield

[8] Nevertheless, the entity would need to consider if similar contracts written in that period would qualify for the simplified approach.

[9] Paragraph BCA167 of the Basis for Conclusions to the 2013 ED

approach is to eliminate accounting mismatches between interest expense on the liabilities and the investment income on the assets when there could be no economic mismatches between them. The fact that an entity does not hold the underlying items would mean that there is a known economic mismatch between the items held and the promise to return the underlying items to the policyholder. Therefore, permitting a current period book yield approach when economic mismatches are known to exist would obscure useful information to users of financial statements. Accordingly, the staff believe that an entity should be required to discontinue the current period book yield approach and instead apply the effective yield approach if the entity no longer holds the underlying items after originally doing so.

53. The staff notes that, if an entity were to change its approach for determining interest expense from period to period, it would result in lack of comparability. To avoid this lack of comparability, the staff also propose that an entity should be permitted to apply a current period book yield approach only from the inception of the contract. Thus, an entity would apply a current period book yield approach to contracts where it expects to hold the underlying items throughout the contract term, and has always held the underlying items.

Question 3: Reassessment
Do you have any questions or comments on when an entity should be required to reassess eligibility for accounting approaches for contracts with cash flows that vary with the returns on underlying items?

Appendix A: Comparison of staff proposals to the CFO Forum approaches

This appendix compares, at a high level, the staff proposals for the measurement of the contractual service margin after initial recognition, and for the current period book yield approach with the proposals from European CFO Forum approach discussed in November 2014.

Unlocking the contractual service margin

A1. The approach described in paragraphs 14-23, in which an entity adjusts the contractual service margin for changes in the expected fee for service, has many similarities to the approach proposed by the European CFO Forum in the November 2014 education session.

A2. In particular:

(a) Both approaches have a consistent measurement at initial recognition, which is also consistent with the measurement of a non-participating contract at initial recognition.

(b) Both approaches arise from the view that a contract with participation feature provides services other than insurance coverage, in particular asset management service. Both result in the effect of the entity's share of the investment returns on underlying items adjusting the contractual service margin (referred to in the CFO Forum proposals as resulting in a "fully unlocked CSM").

A3. However, there are some differences:

(c) The European CFO Forum proposal includes the projected future allocation of returns from specified items the entity holds in the measurement of the insurance contract. In contrast, the staff proposals consider only the cash flows promised to the policyholder that arise from the underlying items specified in the contract the contract. Those cash flows are determined on the basis of returns from the underlying items, but are not the returns themselves. For example, the European CFO Forum proposals would include in the measurement of the

contractual service margin the return on items the entity holds, even when those items do not affect the cash flows promised to policyholders. For example, such items could include derivative instruments that are not included in the underlying items specified in the contract.

(d) The staff note that the European CFO Forum proposals consider separately the effects of options and guarantees. The response to the IASB questions (see Appendix B of Agenda Paper 2 *Cover note*) notes that there is a strong consensus that the time value of options and guarantees should not be mandatorily recorded in profit or loss, and that these changes should be reported consistently in one location. However there are differing views as to whether changes in the value of options and guarantees should be recognised in OCI or as an adjustment to the contractual service margin. The staff proposal would report these changes as part of the variable fee for service, and thus as an adjustment to the contractual service margin.

Book yield

A4. The current period book yield approach proposed by the staff and described in paragraphs 36-46, has a similar outcome to the current portfolio book yield approach proposed by the European CFO Forum in the November 2014 education session, with some important differences. In particular, the current period book yield approach proposed by the staff approach is not a yield on assets, but is a result of mirroring the amounts reported in profit or loss for the underlying items. Accordingly, the current period book yield approach proposed by the staff avoids the additional complexity that would have been created by the CFO Forum's proposed current portfolio book yield approach because:

(a) It is determined on the basis only of the amounts reported in profit and loss for the period. In contrast, the current portfolio book yield proposed by the CFO Forum is determined by determining the basis of the accounting return (or book yield) for specified underlying items, and constructing a yield curve based on the book yield at each reporting

date to cover the duration of projected cash flows of the contracts. As a result, the current period book yield approach proposed by the staff avoids the need to identify the book yield of the different types of underlying items and construct a yield curve.

(b) It is capable of application for a broader range of underlying items. For example, the staff's proposed current period book yield approach would work for FVOCI equities because it does not rely on determining a yield in profit or loss that reflects the dividend treatment. It would also work for assets at cost, such as investment property. For example:

(i) It avoids the need for an entity to adjust the effective interest rate of the underlying items at amortised cost or FVOOCI to reflect the effect of the impairment requirements of IFRS 9. Some entities might have found that adjustment difficult in practice.

(ii) It ensures that the effect of fair value gains and losses or realised gains and losses on the sale of equity instruments measured at FVOCI is reflected in the interest expense reported in the liability. Similarly, it would reflect the effect on profit or loss of rental yield and capital gains and losses of investment property measured at cost.

(iii) It ensures that the effect in profit or loss for underlying items that is a share of a business operation (eg a combination of an investment performance, mortality and cost savings is also reflected in the interest expense reported in the liability.

(c) It eliminates any accounting mismatch that might otherwise arise when impairment losses on financial assets are accounted for using IFRS 9 while the equivalent gains for the insurance contract are accounted for on an expected cash flow basis.

(d) It does not result in any amounts recognised in OCI at inception of the contract, because it is determined by reference to the change in the current value interest expense less the interest expense reported in profit or loss in the period. In contrast, the current portfolio book yield approach proposed by the CFO Forum may result in amounts

recognised in OCI at initial recognition, because of differences between the book yield of underlying items and current rates. Recognising amounts in OCI on initial recognition would be inconsistent with the proposals in the IASB's forthcoming *Conceptual Framework* Exposure Draft.

Appendix B: Proposed accounting for contracts with participation features

	No cash flows that vary with returns from underlying items	Discretionary crediting rate but there is no clearly identified portfolio of underlying items specified in the contract	Contract specifies policyholder receives returns determined by reference to a clearly identified portfolio of underlying items	Contract specifies the policyholder receives returns on underlying items held with no discretion	Contract specifies the policyholder receives returns on underlying items held but subject to discretion
1. Cash flows	Include in measurement all cash flows that related directly to fulfilment of insurance contract, reflecting expectations about how any discretion would be exercised.				
2. Discount rate	Adjust cash flows to reflect the time value of money using a rate that reflects the extent of any asset dependency. When there is no asset dependency, the appropriate rate is risk-free rate plus liquidity premium. Different techniques could be used to meet this objective including eg risk neutral modelling, real world modelling (using the deflators approach), stochastic approaches, etc.				
3. Risk adjustment	Adjust cash flows to reflect compensation for bearing the uncertainty about the amount and timing of cash flows. The risk adjustment reflects all risks associated with the insurance contract, other than those reflected through the use of market consistent inputs. It does not reflect the risks that do not arise from the insurance contract, such as investment risk relating to the assets that an entity holds (except when that investment risk affects the amounts payable to policyholders), asset-liability mismatch risk or general operational risk that relates to future transactions.				
4. CSM at inception	Determined at an amount that is equal and opposite to the sum of the amount of the fulfilment cash flows for the insurance contract at inception.				
5. CSM at subsequent measurement (unlocking) – asset share	When: • there is no clearly identified pool of underlying items; • the policyholder does not retain a share of the returns from underlying items; or • policyholder does not expect a substantial proportion of cash flows the contract to vary with changes in underlying items. Then changes in estimates that arise because of changes in financial assumptions (changes in discount rates) would be recognised in profit or loss or OCI.		When: • there is a clearly identified pool of underlying items; • policyholder expects a substantial proportion of cash flows the contract to vary with changes in underlying items; and • the policyholder expects to retain a substantial share of the returns from underlying items. Then the CSM would be adjusted for the following: • changes in the expected net variable fee for service (ie change in the PV of share of the returns of underlying items); and • changes in the expected present value of the cost of guarantees. This approach treats all changes in estimates arising from changes in financial assumptions as an underwriting effect.		
6. CSM at subsequent measurement (unlocking) – changes in estimates from non-financial assumptions	Adjust CSM to reflect changes in estimates of cash flows and risk adjustment that relate to future service, other than those that arise because of changes in financial assumptions. Changes in estimates that adjust the CSM include those that arise as a result of the application of any discretion.				

	No cash flows that vary with returns from underlying items	Discretionary crediting rate but there is no clearly identified portfolio of underlying items specified in the contract	Contract specifies policyholder receives returns determined by reference to a clearly identified portfolio of underlying items	Contract specifies the policyholder receives returns on underlying items held with no discretion	Contract specifies the policyholder receives returns on underlying items held but subject to discretion
7. Allocation of CSM (see Agenda Paper 2C)	Allocate on basis of passage of time. As a consequence of the level of aggregation principles, this would mean that the CSM recognised in profit or loss would reflect the number of contracts remaining in force.				
8. Discount rate for accretion of CSM and unlocking	Reflects that the consideration for the contract is not affected by current value of underlying items. • Accrete interest on the CSM using a locked-in rate at inception of contracts. • Determine the PV of changes that estimate that unlock the CSM using a locked-in rate.		Reflects that the consideration for the contract varies according to the current value of underlying items. • No need to accrete interest on the CSM as the measurement of the value of the underlying items already reflects the time value of money in the obligation. • Determine the PV of changes that estimate that unlock the CSM using the current liability rate at reporting date.		
9. OCI	If using an OCI accounting policy, the objective is to eliminate accounting mismatch in profit or loss between insurance investment expense on the liability and the investment income on related assets.				
	When the performance of underlying items cannot all be attributed to the policyholder, apply an **effective yield approach**. This is the case when: • contracts not in scope of unlocking for asset share; or • the entity does not holds the underlying items. The entity recognised in profit or loss an amount of insurance investment expense determined using the effective yield approach. The entity recognises in OCI the effect of changes in discount rates. This includes both: • the effect of changes in discount rates on fixed cash flows; and • changes in cash flows that vary with changes in interest rates and the effect of any discount rate changes on those cash flows (if any) **.**		Apply a **current period book yield approach** only when: • contracts are in scope for unlocking for asset share; and • entity expected at inception to hold the assets and has held the assets in each reporting period. In all other cases apply an **effective yield approach.**	When the performance of underlying items is all attributable to the policyholder, apply a **current period book yield approach**. This is the case when: • contracts in scope for unlocking asset share; and • The entity holds the underlying items The entity recognises in profit or loss an amount of insurance investment expense determined so that there is no net investment margin on the underlying items in profit or loss. The difference between the current value interest expense and the current period book yield is recognised in OCI.	
10. Reassessment of eligibility	Determine accounting approach at inception with no reassessment.				

Appendix C: Where changes in estimates are recognised

<table>
<tr><th></th><th>No cash flows that vary with returns from underlying items</th><th>Discretionary crediting rate but there is no clearly identified portfolio of underlying items specified in the contract</th><th colspan="2">Contract specifies policyholder receives returns determined by reference to a clearly identified portfolio of underlying items</th><th>Contract specifies the policyholder receives returns on underlying items held with no discretion</th><th>Contract specifies the policyholder receives returns on underlying items held but subject to discretion</th></tr>
<tr><th></th><th></th><th></th><th>Entity does not hold underlying items</th><th>Entity holds underlying items</th><th></th><th></th></tr>
<tr><td colspan="7">For assets held by the entity</td></tr>
<tr><td>What is recognised in P&L</td><td colspan="6">Investment income on assets held by the entity, according to other IFRSs.</td></tr>
<tr><td>What is recognised in OCI (if applicable)</td><td colspan="6">Changes in value of assets held by the entity, according to other IFRSs.</td></tr>
<tr><td colspan="7">For insurance contract liabilities</td></tr>
<tr><td rowspan="2">What is recognised in P&L</td><td colspan="6">• When there is remaining CSM, the allocation of the CSM.
• When the CSM is exhausted, losses on initial recognition and changes in estimates of cash flows and risk adjustment.
• Changes in estimates of cash flows and risk adjustment that relate to past or current period service.
• When the entity chooses a P&L accounting policy, insurance investment expense determined using current rates.</td></tr>
<tr><td colspan="3">When the entity chooses an OCI accounting policy, insurance investment expense determined using an effective yield approach.[10]</td><td>Depends on whether the entity always hold the assets.</td><td colspan="2">When the entity chooses an OCI accounting policy, an amount of insurance investment expense determined so that there is no net investment margin on the underlying items in profit or loss.[10]</td></tr>
<tr><td>What is recognised in OCI (if chosen)</td><td colspan="6">The difference between the current value interest expense and the amounts recognised as interest expense in profit or loss.</td></tr>
<tr><td>What is offset against CSM</td><td colspan="3">• Changes in estimates of cash flows and risk adjustment that relate to future service, other than those that arise because of changes in financial assumptions.</td><td colspan="3">• Changes in estimates of cash flows and risk adjustment that relate to future service.
• Changes in the net variable fee for service, ie the entity’s share of expected asset returns less amounts needed to pay for costs.</td></tr>
</table>

[10] The staff note that the IASB has yet to consider whether to permit or require an OCI approach for contracts with participation features. This table illustrates the accounting if the IASB were to extend its decision from non-participating contracts so that an entity could choose an accounting policy that would enable it to divide insurance investment expense into an amount recognized in profit or loss, and an amount recognized in OCI.