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STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Presentation of interest expense for contracts with participation features—whether to provide an accounting policy choice		

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Purpose of this paper

1. In March 2014 the IASB tentatively decided that for contracts without participation features, an entity should choose as its accounting policy to present the effect of changes in discount rates in profit or loss or in other comprehensive income ('OCI'). Furthermore, that accounting policy choice should apply to all contracts within a portfolio.

2. The IASB has not yet made any tentative decisions on the approaches to determine interest expense for contracts with participation features. The staff's approach for deliberations has been to consider what adaptations to the general model and to the tentative decisions for contracts without participation features would be needed for contracts with participation features. Accordingly, this paper considers whether there should be an accounting policy choice for the use of OCI for contracts with participation features.

Structure of this paper

3. This paper is structured as follows:

   (a) the background section (paragraphs 4-9) explains how allowing an accounting policy choice for presentation of interest expense for contracts without participation features addressed two issues:

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(i) Accounting mismatches

(ii) Costs and complexity

(b) the staff analysis section considers whether the accounting policy choice should be extended for contracts with participation features when entities apply the effective yield approach (in paragraphs 13-19) and the current period book yield approach (paragraphs 20-25).

Background: contracts without participation features

4. The 2013 Exposure Draft *Insurance Contracts* (the '2013 ED') proposed the mandatory use of OCI to present the effect of changes in discount rates for insurance contracts. The key rationale for that proposal was to segregate the presentation of underwriting results from investing results of an entity that issues insurance contracts. According to that proposal:

   (a) interest expense presented in profit or loss would be determined using the discount rates at inception;

   (b) changes in discount rates would be presented in OCI; and

   (c) the measurement of the insurance contract on the balance sheet would not be affected.

5. Most respondents to the 2013 ED agreed that both the amortised cost and current value view provide useful information, and therefore supported the proposal for OCI presentation. However, both supporters and opponents thought that such presentation should not be mandatory.

6. Respondents acknowledged the IASB's reasoning that mandatory presentation in OCI would improve comparability between entities and avoid complexity for users of financial statements. Most respondents to the 2013 ED thought that the costs and complexity arising from accounting mismatches, which would arise if OCI presentation was mandatory, would outweigh the additional complexity for users that would arise if OCI presentation was not mandatory.

7. However, respondents noted that mandatory presentation in OCI:

(a) could not eliminate accounting mismatches in all circumstances. While in some circumstances mandatory presentation in OCI would allow an entity to avoid accounting mismatches in profit or loss (eg when the entity holds assets that are classified at amortised cost or fair value through OCI ('FVOCI')), it would also create accounting mismatches in profit or loss (eg when the entity holds assets classified at fair value through profit or loss ('FVPL')).

(b) could impose a high operational burden because of the need to track and maintain a large number of locked-in yield curves. Some constituents did not believe that this burden would be justified.

(c) could reduce the understandability of the interest expense presented in profit or loss, because that amount would be determined on the basis of a large number of different discount rates.

8. As mentioned in paragraph 2, in March 2014 the IASB tentatively decided that an entity should choose as its accounting policy to present the effect of changes in discount rates in profit and loss or in other comprehensive income. In reaching this conclusion, the IASB sought to balance the sometimes competing demands of understandability and comparability by adopting an approach that:

(a) continues to acknowledge that, when measurement inconsistencies do not result in a lack of faithful representation, it could be appropriate to measure financial assets at FVOCI or amortised cost and present the effect of changes in discount rates on the measurement of insurance contracts in OCI.

(b) allows entities to avoid accounting mismatches when such mismatches would result in financial statements that do not faithfully represent the entity's financial position and performance.

(c) allows entities to avoid the costs and complexity of using OCI when the benefits of doing so do not outweigh those costs (permitting entities to present interest expense using current rate in profit or loss would eliminate the need for additional calculations to derive separate amounts in profit or loss and in OCI).

(d) ensures that the information sought by users of financial statements is provided in disclosures in a way that allows comparison, regardless of whether the effect of changes in discount rate is provided in profit or loss or in OCI.

9. Consequently, entities would need to apply judgement as to the benefits and costs in deciding whether to present changes in discount rate in OCI or in profit or loss.

Staff analysis: application to contracts with participation features

10. The IASB is currently considering two approaches for determining the amounts presented in profit or loss and OCI for contracts with participation features:

    (a) a current period book yield approach, which would apply to contracts where the contract creates an obligation for the entity 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; and

    (b) an effective yield approach, which would apply to all other contracts with participation features.

11. Many interested parties, including those that responded to the 2013 ED proposals, indicated that an accounting policy choice should also be extended to contracts with participation features.

12. In paragraphs 13 –25 the staff examine the extent to which the IASB's rationale for permitting an accounting policy choice for presentation of interest expense for contracts without participation features would apply when entities use each of those two approaches.

Effective yield approach

13. In Agenda Paper 2D *Proposed Accounting for Indirect Participation Contracts* for this meeting, the staff suggest that the IASB should specify a form of the effective yield approach that determines 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.

14. There are many similarities between the effective yield approach, which is described in more detail in Agenda Paper 2D, and the use of locked-in discount rates for contracts without participation features. Similarly to the approach that uses locked-in discount rates, the effective yield approach described in Agenda Paper 2D:

    (a) could provide useful information in some situations (eg when all assets held by the entity to back the insurance contracts are measured at amortised cost or FVOCI and the asset and liability durations are matched); but

    (b) could result in a lack of faithful representation because of accounting mismatches arising from:

        (i) realisations of gains and losses on the sale of an asset accounted for at amortised cost; and;

        (ii) having a mix of assets classified at FVPL and at FVOCI.

15. Additionally, applying the effective yield approach to contracts without participation features where there are no cash flows that vary with asset returns would result in the same outcome as applying locked-in rates.

16. Furthermore, as for contracts without participation features (discussed in paragraph 7):

    (a) An entity applying the effective yield approach to present the effect of changes in discount rates in OCI would need to make additional calculations to derive separate amounts in profit or loss and in OCI.

    (b) The cost of permitting the effective yield approach as an accounting policy choice creates additional complexity for users.

17. Accordingly, a similar rationale to the one for permitting an accounting policy choice for contracts without participation features (see paragraphs 4-9) should apply, ie that:

    (a) the costs, complexity, and the accounting mismatches that the mandatory use of the effective yield approach would outweigh the costs of allowing an entity an accounting policy choice.

(b) the IASB should enable entities to eliminate accounting mismatches in profit or loss, while 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 contracts and the presentation of interest expense.

18. In addition, permitting the same choice of accounting policy for indirect participation contracts and contracts without participation features would avoid differences in the outcome if:

(a) an entity was *required* to apply the effective yield approach to indirect participation contracts, and

(b) an entity could choose as its accounting policy whether to apply the locked-in discount rate approach to contracts without participation features.

Such differences would be difficult to explain.

19. Consequently, the staff believe that an entity should choose as its accounting policy to present interest expense either:

(a) all in profit or loss; or

(b) in profit or loss and OCI using the effective yield approach.

Current period book yield approach

20. Under the current period book yield approach, the entity determines the insurance investment expense 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.

21. The key advantage of the current period book yield approach is that it fully eliminates any accounting mismatch between insurance investment expense on the liabilities and the investment income on the assets when there could be no *economic* mismatch between them. As a result, there is no accounting mismatch, regardless of the type of assets the entity holds. Accordingly, it would not be justified to permit an accounting policy choice on the grounds of allowing an

entity to eliminate an accounting mismatch, as is the case for the locked-in discount rate approach.

22. In addition, the staff think that the current period book yield approach is less complex to apply than the other approaches mentioned in paragraph 19.

23. However, the staff note that complexity for an entity could arise once a portfolio of insurance contracts ceases to qualify for the current period book yield approach after inception. This is because the current period book yield approach would apply only to contracts 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. Those conditions are necessary because they guarantee that there are no economic mismatches. If the current period book yield approach were applied when economic mismatches could exist, then setting the insurance investment expense on the insurance contract liability that is reported in profit or loss as equal and opposite in amount to the investment income on the underlying items could obscure useful information to users of financial statements.

24. Accordingly, an entity applying the current period book yield approach would be required to discontinue that approach if it no longer held the underlying items. The question then arises as to how the entity would present interest expense. The staff think that in these circumstances the entity should be able to apply the approaches for presenting changes in discount rates for contracts that do not qualify for the book yield approach discussed in paragraph 19. In other words, such entities should be able to select an accounting policy for recognising the changes of discount rates in either profit or loss or in OCI (using the effective yield approach).

25. The staff note that contracts qualifying for current book yield approach may in the future no longer qualify, for example, if the entity chooses to hold assets other than underlying items. Thus, an entity would be able to ensure that contracts do not qualify for the current period book yield approach by temporarily not holding the underlying items. In consequence, the entity could be given the opportunity to select an effective yield approach, if the IASB were to agree with the staff proposal in paragraph 19. Therefore, the staff believe that for a contract that

qualifies for the current book yield approach at initial recognition, the entity should have an accounting policy choice to determine interest expense in profit or loss using:

(a) the current period book yield approach;

(b) the effective yield approach; or

(c) current discount rates (ie all in profit or loss).

Question for the IASB
Does the IASB have any views or comments on the conclusions in paragraphs 19 and 25?