

## STAFF PAPER

September 2015

## IASB Meeting

<b>Project</b>	<b>Insurance Contracts</b>		
<b>Paper topic</b>	Disaggregating changes arising from changes in market variables in the statement of comprehensive income—background		
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This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

## Introduction to Agenda Papers 2A–2D

1. In accordance with the IASB’s tentative decisions, insurance contracts are measured using current assumptions and the effect of changes in market variables<sup>1</sup> is recognised in the statement of comprehensive income. In March 2014, the IASB tentatively decided that for contracts *without* participation features, the entity may choose as its accounting policy to disaggregate changes in discount rates between profit or loss and other comprehensive income (OCI). If so:
  - (a) the presentation of the insurance investment expense should be determined using the discount rate locked in at inception (ie a cost measurement basis in profit or loss);<sup>2</sup> and
  - (b) accordingly the difference between the insurance investment expense determined using a cost and a current measurement basis is presented in OCI.

<sup>1</sup> Changes in the discount rate and changes in the amounts of some cash flows are the result of changes in the market variables.

<sup>2</sup> The term ‘insurance investment expense’ is intended to be synonymous with the term ‘interest expense’, which had been used in previous papers. The new term is a better descriptor of the changes that are presented in profit or loss, because those changes may arise from more causes than solely changes in interest rates. For reasons of brevity, the rest of the agenda papers refer to the insurance investment as being an expense. Nevertheless, the decisions are meant to apply equally to when there is insurance investment income.

2. The IASB has not yet made any decisions on the approach(es) to be required when disaggregating changes in discount rates between profit or loss and OCI for contracts *with* participation features. The staff's approach for the deliberations has been to consider what adaptations to the tentative decisions for contracts without participation features would be needed to make them appropriate for contracts with participation features.
3. Accordingly, Agenda Papers 2B–2C consider questions for contracts with participation features on the disaggregation of changes in discount rates between profit or loss and OCI as follows:
  - (a) Agenda Paper 2B considers what the practical mechanics could be when disaggregating changes in market variables between profit or loss and OCI. This would apply to all contracts accounted for under the general model and the variable fee approach.
  - (b) Agenda Paper 2C considers whether different requirements (ie current period book yield) are needed for some specific contracts, in which there are no economic mismatches between the contract and the items held by the entity. These different requirements would apply to a specified subset of contracts accounted for under the variable fee approach.
4. Agenda Paper 2D discusses other issues for contracts with participation features related to disaggregating changes in market variables between profit or loss and OCI as follows:
  - (a) whether such a disaggregation between profit or loss and OCI should be an accounting policy choice; and
  - (b) simplified transitional requirements for the determination of the accumulated balance of OCI when retrospective application is impracticable.

**Introduction to this Agenda Paper**

5. As background to the questions on the disaggregation of changes in discount rates between profit or loss and OCI in Agenda Papers 2B–2C, this Agenda Paper:
- (a) provides a reminder of contracts with participation features and how those contracts are accounted for (see paragraphs 8–11); and
  - (b) summarises the IASB’s previous considerations on the disaggregation of changes in market variables between profit or loss and OCI as follows:
    - (i) for contracts without participation features, the IASB’s tentative decisions to date (see paragraphs 12–15); and
    - (ii) for contracts with participation features (see paragraphs 16–31):
      - 1. the proposals in the 2013 Exposure Draft *Insurance Contracts* (the ‘2013 ED’); and
      - 2. the IASB’s discussions on the potential modifications to the proposals in the 2013 ED.
6. This paper is accompanied by two Appendices:
- (a) Appendix A, which provides further details of the variations of the effective yield approach to disaggregate changes in discount rates between profit or loss and OCI that the IASB has discussed during the redeliberations of the proposals in the 2013 ED; and
  - (b) Appendix B, which sets out relevant paragraphs from the 2013 ED.
7. This paper does not contain any questions for the IASB.

## Contracts with participation features

### *What is a participation feature?*

8. Insurance contracts always provide payments to policyholders that depend on the occurrence of an insured event. These payments may be fixed amounts or may vary. Variation in payments might arise because:
- (a) the entity compensates the policyholder according to the scale or type of loss suffered.
  - (b) the entity provides additional benefits other than the payments that are commensurate to the loss suffered. The determination of these additional benefits may be contractually specified or may be at the discretion of the entity. These additional benefits are termed a ‘participating feature’. The participating feature is the mechanism by which the entity shares additional rewards and risks with the policyholder.<sup>3</sup>
9. There are a variety of factors that determine the additional benefits paid under a participating feature and there is a continuum of the effect of the changes in market variables on the cash flows. For example:
- (a) for some contracts, the contract specifies the linkage between market variables (for example, the value of or return on a pool of assets) and the amounts to be paid out. That linkage can range from specifying how specific market variables affect the determination of cash flows to how the changes in the specified market variables might affect the cash flows.
  - (b) the entity may have the ability to vary the amount and/or timing of the additional benefits paid through discretion and the effect of the market variables on the cash flow amounts, depending on how the entity determines the amount and/or the timing of the additional benefits to

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<sup>3</sup> Examples of contracts with participating features are summarised in Appendix A of Agenda Paper 2A for the May 2014 IASB meeting.

the policyholder. The level of discretion may also differ between contracts.

- (c) for some contracts, market variables are not the sole determinant of the additional benefits. The additional benefits could be a combination of market variables, costs and underwriting gains and losses.

**How is a contract with a participation feature accounted for?**

- 10. Contracts with participation features are accounted for under:
  - (a) the general model, which has requirements that accommodate the participation feature; and
  - (b) the variable fee approach, if these contracts are direct participation contracts. Under the variable fee approach the insurance contract is viewed as an obligation to pay to the policyholder an amount equal to 100% of the fair value of the underlying items less a variable fee for service.
  
- 11. This set of papers discusses how changes in the insurance contract arising from changes in market variables could be disaggregated between profit or loss and OCI. Under the IASB’s proposed approach, changes in the insurance contract arising from changes in market variables are always recognised in the statement of comprehensive income. As a reminder, those changes are as follows:

*For the general model*

- (i) the effects of applying a current discount rate to the measurement of the fulfilment cash flows; and
- (ii) changes in the nominal amounts of the fulfilment cash flows arising due to changes in market variables. This applies to the majority of, if not all, contracts with participation features.

*For the variable fee approach*

- (b) changes in the obligation to pay 100 per cent of the fair value of the underlying items. These changes are a combination of both changes in

the discount rate and changes in the nominal amounts of the fulfilment cash flows.

### **Previous decisions on disaggregation for contracts *without* participation features**

12. The IASB has tentatively decided that for contracts without participation features:
  - (a) the entity may choose as its accounting policy to disaggregate changes in discount rates between profit or loss and OCI; and
  - (b) the mechanics for doing so are:
    - (i) the insurance investment expense in profit or loss is determined using the discount rate locked in at inception (ie using a cost measurement basis in profit or loss); and
    - (ii) the difference between the insurance investment expense measured using the locked-in rate and the current rate is presented in OCI.
13. Appendix B sets out the relevant Basis for Conclusions from the 2013 ED.
14. In tentatively deciding to allow an entity to disaggregate changes in discount rates between profit or loss and OCI, the IASB was persuaded that segregating the effects of changes in the discount rate that are expected to unwind over time from other gains and losses would allow users to better assess the underwriting and investing performance of an entity that issues insurance contracts. However, the IASB also noted that an inherent feature of a cost measurement basis in profit or loss, such as fair value through other comprehensive income (FVOCI), is that accounting mismatches are more likely to arise. This is because recognition of amounts of income and expenses may depend in part on when assets are bought/originated and sold/matured, and when liabilities are incurred and settled. The IASB thought it would be complex to develop an approach that would eliminate accounting mismatches, while at the same time highlighting economic mismatches in profit or loss.
15. Consequently, the IASB decided that an entity could choose as its accounting policy to present the insurance investment expense using a current measurement

basis, which would eliminate accounting mismatches if assets were also measured at fair value through profit and loss (FVPL).

### **Previous discussions on disaggregation for contracts *with* participation features**

16. As discussed in paragraph 2, the IASB has not made any decisions on the mechanics of disaggregating changes in discount rates between profit or loss and OCI for contracts with participation features.
17. The following section summarises:
  - (a) the proposals in the 2013 ED (see paragraphs 18–22); and
  - (b) the IASB’s discussions on the modifications that could be made to the proposals in the 2013 ED (see paragraphs 23–31).

### ***The 2013 ED***

18. The 2013 ED proposed that, when the amounts of some of the cash flows of an insurance contract vary with changes in market variables:
  - (a) changes in the estimates of cash flows arising from changes in market variables (ie what were termed ‘changes in the returns on underlying items’ in the 2013 ED) should be recognised in profit or loss; and
  - (b) the insurance investment expense presented in profit or loss should be calculated as follows:
    - (i) the discount rates applied to cash flows that do not vary with changes in expected investment returns are locked in at initial recognition;
    - (ii) the discount rates applied to cash flows that do vary with changes in expected investment returns are reset every time there are changes in estimates of those investment returns that result in changes in the amounts paid to policyholders; and

- (c) accordingly, the remainder of the effects arising from changes in discount rates is presented in OCI.

*Changes in the estimates of cash flows arising from changes in market variables*

19. The proposal to recognise changes in the estimates of cash flows arising from changes in market variables in profit or loss is consistent with the recognition of changes in estimates of cash flows for financial instruments. For example, changes in estimates in prepayment options for assets measured using amortised cost are recognised in profit or loss.

*The insurance investment expense presented in profit or loss*

20. The reason for resetting the discount rate when there are changes in estimates of market variables that result in changes in the amount of cash flows is that doing so would be consistent with both:
- (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 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 represent the economic effects of such a change in market variables. This is because a change in market variables also changes the amount of some of the cash flows.
  - (b) the accounting for floating-rate debt instruments that are not accounted for at FVPL (for example, at FVOCI). For floating-rate debt instruments accounted for at amortised cost, the locked-in discount rate used to present insurance investment expense is reset upon changes in interest rates.
21. 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. The cash flows



would need to split into those that are affected by market variables and those that are not affected by market variables and the entity would need to apply different discount rates to the two types of cash flow.

22. In addition, the 2013 ED proposed a measurement and presentation exception for some types of contracts with participating features. This exception is commonly referred to as the ‘mirroring exception’. The mirroring exception was intended to eliminate all accounting mismatches between the cash flows of the contract and the cash flows of the items held and would apply only to contracts for which there could be no possibility of an economic mismatch. The 2013 ED specified that this would be the case for contracts for which the entity is required to pass on returns from underlying items to the policyholder and for which the entity is required to hold those underlying items.

***Redeliberations discussions***

23. During its 2014 and 2015 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 insurance investment expense to be presented in profit or loss. This is because most entities do not split the cash flows in the way proposed by the IASB in the 2013 ED; and
  - (b) some did not think that 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.

*Effective yield approach: applying updated discount rates to all the cash flows in the contract*

24. At its July 2014 meeting, the IASB agreed that it should try to avoid an approach to disaggregate the effect of changes in discount rates that would result in the need to split the cash flows with different characteristics within a contract, because it would introduce complexity and arbitrariness that would not be justified.

Consequently, the IASB explored an effective yield approach to disaggregate the changes in discount rates between profit or loss and OCI, which would apply an updated discount rate to all the cash flows of the contract. The effective yield approach is a cost measurement basis for presentation in profit or loss.

Accordingly, the changes arising from changes in discount rates are disaggregated by presenting a cost measurement basis in profit or loss and the difference between a cost measurement basis and a current measurement basis in OCI.

25. The effective yield approach would determine the discount rate for the presentation of insurance investment expense in profit or loss, based on the effective interest method which is used in IFRS 9 *Financial Instruments*. The effective interest method is used to calculate the amortised cost of a financial instrument and to allocate the interest income or insurance investment expense on the financial instrument over the relevant period.
26. The effective yield approach could be used to disaggregate the changes in discount rates between profit or loss and OCI for contracts accounted for under both the general approach and the variable fee approach.
27. However, the IASB also noted that, conceptually for an insurance contract, it is appropriate to apply updated discount rates only to cash flows whose amounts vary with market variables. Locked-in discount rates should be applied to cash flows that do not vary with investment returns. Consequently, an approach that applied updated discount rates to all the cash flows of the contract would need to be restricted to instances in which the amount of the cash flows that will vary with market variables are expected to be the predominant component in the contract.
28. Consequently, in July 2014, the IASB indicated that the staff should explore an effective yield approach only for contracts in which a substantial proportion of cash flows vary with asset returns.

29. In September 2014, the IASB considered the following variations of the effective yield approach:<sup>4</sup>
- (a) a level yield method that would determine the insurance investment expense in profit or loss using a discount rate that exactly reverses out any amounts recognised in OCI over the life of the contract;
  - (b) a projected crediting variation that reflects the pattern of expected crediting rates; and
  - (c) a modified effective yield approach that would address the accounting mismatches that may arise between insurance investment expense and investment income in circumstances in which:
    - (i) the items are a mix of assets measured at FVPL and cost; and
    - (ii) the 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.

Appendix A provides a summary of the rationale for these variations.

#### *Current period book yield approach*

30. An inherent feature of a cost measurement basis in profit or loss, such as all the variations of the effective yield approach discussed in paragraph 29, is the high likelihood that accounting mismatches will arise between income and expenses (see paragraph 14).
31. The IASB also explored whether, in the limited circumstances in which there are no economic mismatches between the contract and the items held by the entity, an approach that eliminates accounting mismatches in profit or loss could be used to disaggregate changes in the insurance contract arising from changes in market variables. That approach is termed the current period book yield approach and is discussed in Agenda Paper 2C.

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<sup>4</sup> See paragraphs 38–67 of Agenda Paper 2A for the September 2014 IASB meeting.

**Appendix A****Rationale behind the variations for the effective yield approaches**

A1. The following paragraphs describe the rationale for the variations of the effective yield approaches previously explored by the IASB.

***Level yield method***

- A2. The level yield method would determine the insurance investment expense by using a discount rate instead of a yield curve as proposed in the 2013 ED. Thus, the effective yield approach would average the differences between the discount rates for each period/tenor across the yield curve and may further reduce the accounting mismatch in profit or loss when the related assets are measured on a cost measurement basis in profit or loss.
- A3. In its simplest form, an effective yield is calculated on initial recognition of a contract as a rate that exactly discounts the estimates of the expected future cash flows to the carrying amount of the liability, which is determined on a cost measurement basis at the reporting date.
- A4. The effective yield is reset when there are changes in the amounts expected to be paid to policyholders because of changes in the estimated investment returns. The level effective yield is the rate required to accrete, on a level yield basis, the cost liabilities measured immediately before a change in the estimated cash flows in order to equal the revised expected cash flows when they take place.
- A5. The resetting of the effective yield means that the insurance investment expense in profit or loss is affected by the effects of the changes in the estimated investment returns on the expected cash outflows from the contract. This effect arises because the effective yield is determined based on all the expected cash flows from the contract.

***Projected crediting rates***

A6. For some contracts with participating features, there is an account balance with a crediting rate and information about the account balance and the crediting rate is accessible to the policyholder (ie sometimes termed ‘an explicit account

balance'). The effect of the account balance and the annual crediting rate on the expected cash flows to the policyholder can vary between contracts.

- A7. When the account balance and the annual crediting rate make up a significant driver of the expected cash flows to the policyholder, some have recommended that the insurance investment expense presented in profit or loss using a cost measurement basis should reflect the pattern of the annual crediting rate. Consequently, the insurance investment expense in a period will reflect the actual crediting rate in the period. Those recommending a projected crediting rate approach believe that this provides a more faithful reflection of a cost measurement basis in profit or loss than a level yield method. Under the projected crediting rate method, the insurance investment expense in the period reflects the impact of changes in market variables on the amounts that would need to be paid today. Instead, they note that the level yield method would result in an insurance investment expense for the period that reflects both the cost and the current expectations of changes in market variables.
- A8. They also note that in some circumstances the projected crediting rate produces an insurance investment expense that reduces accounting mismatches further than the level yield method. This would be the case when the crediting rate of a specified period is determined by the coupon of bonds received in that period and the investment income recognised in profit or loss is similar to the coupon received.

### ***Assets measured using both a current and a cost measurement basis***

- A9. In some cases, a portfolio of contracts with participating features is backed by a mixture of assets accounted for at fair value through profit or loss (FVPL), fair value through other comprehensive income or amortised cost. When this is the case, accounting mismatches could be avoided by modifying the effective yield approach so that it reflects the mix of assets held. To do this the entity would need to determine a weighting between locking in the discount rate using the effective yield approach and the current discount rate. For example, the entity determines that 70 per cent of its assets held to back insurance contracts are accounted for at FVPL and 30 per cent at amortised cost. The discount rate used

for the presentation of insurance investment expense would be a weighted average of the current discount rate used to measure the liability and the locked-in discount rate determined using the effective yield approach, at a ratio of 70:30 respectively.

***Realisations of assets measured using a cost measurement basis in profit or loss***

A10. In its simplest form, the effective yield approach does not reflect the timing of the realisation of any assets the entity holds that are measured using a cost measurement basis in profit or loss. As a result, there may be situations in which there is a realisation in profit or loss of gains and losses from assets measured using a cost measurement basis in profit or loss, but there is no corresponding increase in the cash flows for the insurance contract liability in the period of realisation. Some think that this would create accounting mismatches that could be avoided if the effective yield approach were to be modified to eliminate the timing difference that arises between when the entity reports gains and losses on the assets in profit or loss and when the entity increases the amounts that it assigns to policyholders relating to those gains or losses. To do this, the entity would need to reset the effective interest at the date of realisation so that it reports a gain or loss for an insurance investment expense in profit or loss, to offset the gain or loss reported on the sale of the asset. At the same time the entity would unwind the gains and losses recorded in equity (sometimes recorded as ‘accumulated other comprehensive income’) over the life of the contract.

## Appendix B

### Relevant extracts from the Basis for Conclusions on the 2013 ED

#### Interest expense in profit or loss (paragraphs 60(h) and 61–65)

- BC117 The 2010 Exposure Draft proposed a current measurement for insurance liabilities with all changes in the liability recognised in profit or loss. However, many respondents were concerned that gains and losses from underwriting and investing activities would be obscured by more volatile gains and losses arising from changes in the current discount rate that is applied to the cash flows in insurance contracts. In particular, these respondents noted that, when the amounts paid to the policyholder do not depend on market interest rates, changes in discount rates cause changes in the present value of cash flows, even though the ultimate amount paid to policyholders does not change.
- BC118 Furthermore, in the responses to the 2010 Exposure Draft, many preparers expressed the concern that the requirement to use a current value measurement for insurance liabilities, specifically to remeasure insurance contract liabilities for changes in interest rates, would mean that entities would be forced to exercise the fair value option for financial assets in order to avoid the accounting mismatches that would arise between assets measured at amortised cost and insurance contract liabilities. They noted that the IASB has indicated that amortised cost is an appropriate measure for financial assets in some circumstances and that IFRS would generally require an entity to measure financial liabilities at amortised cost. Accordingly, they believe that the volatility in profit or loss that would result from a current value measurement of insurance contracts would not result in a faithful representation of their economic performance and would not provide comparability across entities without significant insurance contract liabilities.
- BC119 The IASB is unconvinced that entities that issue insurance contracts would be disadvantaged if insurance contracts were to be measured at current value. However, 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. Thus, an entity would:
- (a) report a current view of performance in total comprehensive income; and
  - (b) recognise in other comprehensive income the difference between the effects of discounting the cash flows at a current rate at the end of the period and the amortised cost view of the time value of money.
- BC120 This would separate the effects of changes in cash flow estimates from the effects of changes in discount rates and would provide users of financial statements with information about the time value of money that the entity determined at contract inception.
- BC121 Similar to financial assets mandatorily measured at fair value through other comprehensive income in accordance with the 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)), the amounts recognised in profit or loss and other comprehensive income would differ depending on the characteristics of the cash flows arising from the insurance contract:
- (a) some payments to policyholders are not expected to vary with changes in interest rates. The interest expense recognised in profit or loss would be measured using the discount rate at contract inception. This is similar to the way the interest revenue is measured for a fixed-rate financial asset (see paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement*). The difference between the effects of discounting those cash flows at a current rate at the end of the period and the effects of discounting those same cash flows at the rate that applied at initial recognition would be recognised in other comprehensive income and would unwind automatically over time. This is similar to recognising gains or losses in other comprehensive income for financial assets mandatorily measured at fair value through other comprehensive income (see paragraph 5.7.1A of the 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010))).
  - (b) some cash flows in a contract are expected to vary with returns on underlying items. Changes in interest rates for underlying items that affect the returns on those underlying items may cause changes in the cash flows in an insurance contract. These cash flows have

similar economic features to floating rate interest payments on financial instruments. As a result, the IASB believes that portraying the interest expense as if it resulted from a financial instrument with a fixed interest rate would not provide useful information. Accordingly, the IASB decided that, when the estimates of cash flows are expected to vary with returns on underlying items, the discount rate applied in determining interest expense recognised in profit or loss on those cash flows should be updated when the entity revises the estimates of those cash flows. This is similar to the requirement in IAS 39 that, for floating rate financial assets, movements in market rates of interest alter the effective interest rate (see paragraph AG7 of IAS 39).

### Complexity

- BC127 The IASB's revised proposals respond to comments on the 2010 Exposure Draft. However, they would introduce more reporting complexity than the 2010 Exposure Draft, which proposed to recognise all changes in the insurance contract liability in profit or loss. This reporting complexity could reduce the usefulness of the financial statements to users of financial statements, specifically:
- (a) some are concerned that the effect of the accounting mismatches would obscure the entity's underwriting and investment performance. This is because, except in the limited circumstances described in paragraph BC46, entities would not be able to avoid accounting mismatches when the assets that back the insurance contracts are measured other than at fair value through other comprehensive income.
  - (b) some are concerned that information about the effect of duration mismatches and some options and guarantees embedded in insurance contracts would be obscured, because part of those effects would be recognised in other comprehensive income and part in profit or loss. This concern is exacerbated because this Exposure Draft would recognise changes in the value of some options embedded in insurance contracts wholly in profit or loss if the contract requires the entity to hold underlying items and specifies a link to those underlying items. Thus, there would be an inconsistent presentation of changes in the value of options and guarantees embedded in insurance contracts, depending on whether the options and guarantees are embedded in a contract that requires the entity to hold underlying items and specifies a link to returns on those underlying items.
  - (c) some believe that the amount recognised in other comprehensive income would be difficult to understand because it combines the effects of changes in discount rates for the period with the effect of the unwinding of the cumulative difference between the original and current rates. This is equally the case for amounts recognised in other comprehensive income when financial assets are measured at fair value through other comprehensive income, as proposed in the IASB Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9*.
- BC128 Furthermore, the proposals would introduce costs for many preparers of financial statements. Preparers would be required to measure the insurance contract liability on a current basis in the statement of financial position and on a different basis for presentation in profit or loss. The presentation basis would require preparers:
- (a) to apply different discount rates to different contracts according to their date of initial recognition, rather than applying only the current discount rate to all cash flows; and
  - (b) to update the discount rate when the cash flows are expected to vary with returns on underlying items.
- BC129 As with the proposals for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items, the IASB's proposals for interest expense would restrict the entity's ability to apply different approaches to measure the insurance contracts, described in BC57. This is because a single discount rate and a single approach to discounting may not represent faithfully the cash flows of a contract if that contract generates different sets of cash flows and those sets are expected to vary in different ways with returns on underlying items. As a result, entities would be required to identify the cash flows with different characteristics and:
- (a) for the cash flows that are not expected to vary with returns on underlying items:
    - (i) recognise interest expense in profit or loss using the discount rates that applied when the contract was initially recognised; and



- (ii) recognise in other comprehensive income the difference between discounting the cash flows using a current rate and discounting the cash flows using the rate in (i).
- (b) for the cash flows that are expected to vary directly with returns on underlying items:
  - (i) recognise interest expense in profit or loss using the discount rates that applied when the contract was initially recognised. The discount rates are updated when the entity expects changes in the returns on underlying items to affect the amount of the cash outflows.
  - (ii) recognise in other comprehensive income the difference between discounting the cash flows using a current rate and discounting the cash flows using the rate in (i).

BC130 As noted in paragraph BC58, any decomposition of cash flows is, to some extent, arbitrary. The different ways in which an entity might identify which of the cash flows that are expected to vary directly with returns on underlying items would result in different amounts being recognised in profit or loss and other comprehensive income. Thus, to increase comparability, the IASB proposes a similar decomposition to determine the fixed cash flows in an insurance contract as would be applied in decomposing the cash flows in contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. That approach:

- (a) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and
- (b) identifies the minimum fixed payment that the policyholder will receive.

BC131 As a result, the effects of changes in the discount rates that are recognised in other comprehensive income for fixed cash flows are comparable for all insurance contracts.

BC132 The IASB concluded that this operational complexity is justified because segregation of gains and losses that are expected to unwind over time from other gains and losses would enable users of financial statements to understand the underwriting and investing performance of an entity that issues insurance contracts.

### **Other approaches considered but rejected**

BC133 Paragraphs BC117–BC121 explain that this Exposure Draft places greater weight than did the 2010 Exposure Draft on separating underwriting and investing performance from changes that unwind over time. Before concluding on the proposal in this Exposure Draft, the IASB also considered:

- (a) other approaches for segregating changes that arise from movements in discount rates from other gains and losses (see paragraphs BC134–BC147); and
- (b) other approaches for determining the amount to be recognised in other comprehensive income (see paragraphs BC148–BC159).

### *Segregating changes that arise from movements in discount rates*

BC134 The IASB considered the following other approaches for segregating changes that arise from movements in discount rates from other gains and losses:

- (a) segregating changes that arise from movements in discount rates within profit or loss (see paragraphs BC135–BC141);
- (b) permitting an option to recognise in profit or loss the interest expense that is measured using the current rate (see paragraphs BC142–BC145); and
- (c) recognising interest income in other comprehensive income for all assets that back insurance contracts (see paragraphs BC146–BC147).

### **Segregating changes that arise from movements in discount rates within profit or loss**

BC135 Some suggest that the IASB’s proposals for segregating underwriting and investing performance from changes that unwind over time would cause operational complexity that is not justified for some entities. For example, some entities manage asset and liability portfolios with limited interest and duration risks, and the users of the financial statements of these entities may not be concerned about the limited reported volatility that would arise. Furthermore, some entities are accustomed to

explaining reported volatility under their existing accounting practices. Thus, the users of the financial statements of some entities may not be concerned about reported volatility. Nonetheless, all entities would be required to apply the proposals in the proposed Standard and would be subject to the additional operational costs that would result from the proposal to disaggregate the effects of discounting in other comprehensive income.

- BC136 Some maintain that the most effective way of reducing accounting mismatch would be to recognise all changes in the insurance contracts liabilities in profit or loss, as proposed in the 2010 Exposure Draft. Consequently, the reporting entity could reduce accounting mismatches by choosing to apply existing fair value options in IFRSs, for example, for financial assets or investment property.
- BC137 Accordingly, some suggest that all entities should recognise all gains and losses in profit or loss, and those entities for which the distinction between underwriting and investing performance is important should instead use the flexibility offered in IAS 1 *Presentation of Financial Statements*, which permits entities to segregate information within profit or loss. For example, some suggest that useful, disaggregated information could be achieved by segregating components of the changes in the insurance liability within profit or loss. Some changes could be presented as operating profit. Other changes, such as the effects of changes in the discount rate, could be presented below the operating profit line, within profit or loss. Operating profit could be useful:
- (a) to highlight underlying performance when the assets backing insurance contracts are measured at fair value through profit or loss; and
  - (b) to reduce the effects of the accounting mismatches in profit or loss when the assets backing insurance contracts are measured at fair value through other comprehensive income or amortised cost.
- BC138 Those who support presenting all changes in profit or loss further believe that:
- (a) regardless of whether changes in the discount rate are short or long term, those changes are economic and may be useful in analysing an entity's performance;
  - (b) while the recognition of changes in the discount rate in profit or loss may result in reported volatility in profit or loss, that volatility would be mitigated because accounting mismatches would not occur if an entity's assets were measured at fair value with changes recognised in profit or loss; and
  - (c) the use of other comprehensive income should be minimised, particularly because, at this time, there is no general principle for when it should be used, and because it adds complexity to reporting.
- BC139 However, some responses to the 2010 Exposure Draft suggested that the operational and reporting complexity described in paragraphs BC127–BC132 would be outweighed by the benefits of more relevant and transparent information about the underwriting and investing performance of insurance contracts. In reaching the proposals in this Exposure Draft, the IASB placed greater weight on those arguments.
- BC140 Furthermore, the IASB considered that it is beyond the reasonable scope of this project to develop a comprehensive definition of operating profit. That would require the IASB to consider whether to include or exclude many items that are not related only to insurance contracts. In addition:
- (a) because operating profit is not defined elsewhere in IFRS, any such approach would create an industry-specific presentation for the statement of profit or loss and other comprehensive income, which would be inconsistent with the IASB's intention not to create an industry-specific Standard; and
  - (b) a separate presentation within profit or loss would not alleviate the operational complexity that is associated with the need to measure the components separately.
- BC141 Accordingly, the IASB rejected this approach.

### **An option to recognise all gains and losses in profit or loss**

- BC142 The IASB considered whether it should make the presentation of changes in the insurance contract liability in other comprehensive income an option rather than a requirement. An option could either be unrestricted, or restricted to circumstances in which the exercise of the option would significantly eliminate accounting mismatches. Such options would ensure that preparers would not have to suffer the complexity that is inherent in the IASB's revised decisions if they believed that the information provided in their circumstances does not warrant the cost of the complexity.

BC143 However, the IASB concluded that an unrestricted option would result in a lack of comparability and could reduce transparency across entities that issue insurance contracts. The IASB’s objective in requiring the presentation of the effects of changes in discount rates on the insurance contract liability in other comprehensive income is to separate underwriting and investing performance from the effects of the changes in those discount rates that unwind over time. That objective would not be achieved if entities were permitted an unrestricted option to recognise those changes in profit or loss.

BC144 Some suggested an approach similar to the existing option in IFRS 9 that permits an entity to measure a financial asset at fair value through profit or loss (the ‘fair value option’) if it reduces or eliminates accounting mismatches. However, the IASB observed that a similar option for insurance contract liabilities would be problematic because:

- (a) applying such an option to an individual insurance contract is the best way to fully eliminate accounting mismatches. It is also consistent with the application of the fair value option for financial assets. However, applying such an option at an individual insurance contract level may be operationally complex and may not provide useful information. This is because insurance contracts and associated assets are typically managed at a more aggregated level. Nonetheless, it would be difficult to achieve the objective of reducing or eliminating accounting mismatches through the use of a fair value option for insurance contracts because accounting mismatches would not be eliminated overall if an entity applied an option to recognise in profit or loss all changes in the value of insurance contracts at:
  - (i) an entity level, because an entity may have different portfolios that it manages in different ways.
  - (ii) a portfolio level, because an entity may hold assets that are measured using a mix of measurement attributes (for example, at fair value through profit or loss, amortised cost or fair value through other comprehensive income) and the mix of measurement attributes in the portfolio may change over time. Accounting mismatches would be reduced only if the entity exercises the option to measure all the assets at fair value through profit or loss.
- (b) it would be necessary to specify whether an entity should be permitted or required to invoke or revoke any such option, and in what circumstances. For financial assets, the application of the fair value option in IFRS 9 is available only at initial recognition and is irrevocable. This ensures that entities do not invoke or revoke the fair value option in a particular period to achieve a particular accounting result for that period. However, an irrevocable option would not necessarily reduce or eliminate accounting mismatches if the duration of insurance contracts and the assets backing the insurance contracts differed. An entity would only be able to assess whether the accounting mismatches would be reduced or eliminated when the duration of either the insurance contract or the backing assets ended. While the exercise of the option might reduce accounting mismatches in the short term, it could exacerbate those accounting mismatches in later periods. This would be especially of concern because of the extent of the duration mismatches that might arise between assets and liabilities.

BC145 Consequently, the IASB concluded that permitting an option for entities to recognise all gains and losses from insurance contracts in profit or loss would introduce additional complexity for preparers to operate the option and for users of financial statements to understand the result. Taken together with the lack of comparability that would result from an option, the Board concluded that the cost of that complexity is not justified by the benefits of reduced mismatches for some entities. This would be the case regardless of whether the option was unrestricted, or restricted to circumstances in which the exercise of the option would significantly eliminate accounting mismatches.

**Assets that back insurance contracts**

BC146 Some suggest that measuring and reporting both assets and liabilities at fair value through other comprehensive income would segregate the effects of changes in the discount rate from other gains and losses while avoiding accounting mismatches.

BC147 While the IASB believes that accounting mismatches should be eliminated or reduced to the best extent possible, it noted that this would only be possible if either all the changes in the insurance contracts were recognised in profit or loss, as discussed in paragraph BC136, or if all of the assets that the entity holds to back those contracts were measured at fair value through other comprehensive

income. In the IASB's view, it would not be appropriate to change the accounting for assets for an entity that issues insurance contracts, because:

- (a) it would be undesirable to create industry-specific requirements for the accounting for assets, because doing so would reduce comparability between entities that issue insurance contracts and other entities; and
- (b) identifying which of the entity's assets are held to back insurance liabilities introduces subjectivity and may be arbitrary.

### *Other approaches to measuring interest expense*

BC148 The IASB's proposals would require an entity to recognise, in profit or loss, interest expense that is consistent with the interest revenue recognised for financial assets measured at fair value through other comprehensive income. The IASB also considered, but rejected, recognising in profit or loss interest expense measured:

- (a) using the current discount rate at the start of each reporting period (see paragraphs BC150–BC153);
- (b) using the discount rate at contract inception and accelerating the reclassification to profit or loss of amounts recognised in other comprehensive income when the entity expects that the assets viewed as backing the insurance contract liability will not produce sufficient returns to fulfil the entity's obligation (sometimes called a 'loss recognition test'; see paragraphs BC154–BC157); and
- (c) using the book yield (see paragraphs BC158–BC159).

BC149 The FASB proposes updating the discount rates to rates that recognise estimated interest crediting on a level yield basis over the remaining life of the portfolio of contracts when the entity expects changes in the expected returns on underlying items to affect the amount of the cash flows to the policyholder. The IASB did not consider that approach. After the date that the cash flows are updated, the mechanics of that approach would recognise in profit or loss interest expense that is determined in a different way from how interest expense is determined in the period prior to the first updating of those cash flows. In addition, this approach would recognise some changes in cash flow estimates (ie those attributable to estimated interest crediting) in other comprehensive income or as an adjustment to the contractual service margin as appropriate. This is inconsistent with the recognition of other cash flow changes immediately in profit or loss.

### **Current discount rate at the start of each reporting period**

BC150 The IASB considered an approach in which:

- (a) interest expense recognised in profit or loss on the insurance liability would be based on the current discount rates at the start of the reporting period, applied to the carrying amount at the start of the period; and
- (b) the effects of changes in the discount rate during the reporting period on the insurance liability would be recognised in other comprehensive income.

BC151 Proponents of this approach believe that it would provide useful information to users of financial statements, because it would isolate in other comprehensive income only the effects of changes in the discount rate in the current period.

BC152 However, the IASB rejected this approach for the following reasons:

- (a) amounts recognised in other comprehensive income would not unwind over the life of the contracts that generated them.
- (b) it would introduce accounting mismatches in profit or loss. These accounting mismatches would arise because the interest expense recognised in profit or loss for the insurance contract would be measured using the contract's discount rate at the start of the reporting period (the 'current rate'). The interest income for the assets would be based on a rate that is determined on initial recognition if those assets are required to be measured at amortised cost or at fair value through other comprehensive income.
- (c) entities that issue insurance contracts would need to measure their assets at fair value through profit or loss to reduce accounting mismatches with insurance contract liabilities

measured at current value. As noted in paragraph BC118, some entities that issue insurance contracts believe that a requirement to measure their insurance contracts at current value would mean that entities would be forced to exercise the fair value option for financial assets. These entities believe that amortised cost is the most appropriate measurement basis for assets held to collect principal and interest.

- BC153 The IASB concluded that this approach has no advantage over an approach that recognises interest expense based on the current discount rate at the end of the reporting period, and would be more complex to implement.