STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Disaggregating changes arising from changes in market variables in the statement of comprehensive income—objective		
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Introduction

1. The IASB has not yet made any tentative decisions on the approach(es) to be required when disaggregating changes for contracts with participation features arising from market variables between profit or loss and other comprehensive income (OCI). Agenda Paper 2A summarises the IASB's previous considerations.

2. As a reminder, contracts with participation features are accounted for under:

   (a) the general model. The general model has requirements that accommodate the participation feature. The changes in the measurement of the insurance contract arising from the changes in the market variables are:

      (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.

   (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 the fair value of the underlying items less a variable fee for service.

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The changes in the measurement of the insurance contract arising from the changes in the market variables are changes in obligation to pay 100% of the fair value of the underlying items. Those changes are a combination of both changes in the discount rate and changes in the nominal amounts of the fulfilment cash flows.

3. This Agenda Paper discusses, for contracts with participation features:

   (a) where in the statement of comprehensive income (ie in profit or loss or OCI) should changes in the cash flow amounts resulting from changes in market variables be presented in paragraphs 7-9; and

   (b) the mechanics of disaggregating changes in market variables between profit or loss and OCI for contracts with participation features accounted for in paragraphs 10-19.

4. This Agenda Paper considers all contracts with participation features (ie those that that are accounted for under the general approach and those accounted for under the variable fee approach). Agenda Paper 2C considers whether the decisions reached in this Agenda Paper should be modified for contracts in which economic mismatches do not exist with the items held by the entity. Such contracts are a subset of contracts accounted for under the variable fee approach. The modification proposed would be to require entities to apply an approach for such contracts that would eliminate accounting mismatches in profit or loss (ie the current period book yield approach).

5. Staff also considered whether the analysis and conclusions reached for contracts with participation features also apply to contracts *without* participation features.

Recommendation

6. For all contracts accounted for in the forthcoming Standard, the staff recommend:

   (a) that the changes in estimates of the amounts of cash flows resulting from changes in market variables should be presented in the statement of comprehensive income consistently with the changes in discount rates. This is discussed in paragraphs 7-9;

   (b) that the forthcoming Standard should:

(i) specify that the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI is to present an insurance investment expense in profit or loss using a cost measurement basis. Accordingly, the difference between an insurance investment expense using a cost measurement basis and current measurement basis is recognised in OCI and those amounts reverse; and

(ii) not specify detailed mechanics for the determination of the insurance investment expense using a cost measurement basis.

This is discussed in paragraphs 10-19.

Where changes in the cash flow amounts resulting from changes in market variables should be presented in the statement of comprehensive income

Background

7. The Exposure Draft *Insurance Contracts* (the 2013 ED) proposed that changes in estimates of the amounts of cash flows arising from changes in market variables should be recognised in profit or loss. Changes in estimates of the amounts of cash flows arising from changes in market variables are likely to arise for the majority of, if not all, contracts with participation features. 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.

8. Feedback on this proposal was mixed:

(a) a few respondents recommended that all cash flows should be treated consistently and, therefore, they believe that all changes in estimates should adjust the margin.

(b) when the assets are measured at fair value through profit or loss, some supported the 2013 ED proposals to recognise the equivalent changes in the liability in profit or loss.

(c) when the entity presents the effects of changes in the discount rate in OCI, some thought that it would be more useful to recognise the equivalent changes in the liability in OCI.

Staff analysis

9. Staff recommends that changes in estimates of the amounts of cash flows arising from changes in market variables should be presented in the statement of comprehensive income using the same requirements applicable to the effects arising from changes in discount rates. Changes in discount rates are also changes in market variables. Accordingly, the effects of market variables, resulting in both changes in discount rates and cash flow amounts, will be presented in a consistent location in the statement of comprehensive income. The staff thinks that doing so will result in more understandable information. In addition, the staff notes that presenting changes in cash flows amounts that result from changes in market variables in the statement of comprehensive income consistently with changes in discount rates is less complex operationally to apply. Applying requirements to changes in cash amounts that result from changes in market variables that are different from changes in discount rates will require additional calculations.

Question 1: Changes in estimates of cash flows arising from changes in market variables
Does the IASB agree, for all insurance contracts, that the entity shall present changes in estimates of the amount of cash flows that result from changes in market variables in the statement of comprehensive income consistently with the changes in discount rates?

Disaggregating changes in market variables between profit or loss and OCI

Background

10. The IASB has previously discussed various practical mechanics of disaggregating changes arising from changes in market variables in profit or loss by determining the insurance investment expense in profit or loss as follows (further details are in Agenda Paper 2A):

    (a) A yield curve approach which is reset when changes in market variables causes changes in the amounts of cash flows in a contract.

    (b) The level yield approach which uses a rate that exactly discounts estimates of expected future cash flows to the carrying amount of the liability determined on a cost basis at the reporting date. The level yield approach is a variation of the yield curve approach.

    (c) The projected crediting method, which is a modification of the level yield approach to reflect the amounts credited to the policyholder's account balance in the current and future reporting periods.

    (d) Both the level yield approach and the projected crediting method can be further modified to address accounting mismatches arising from a pool of assets that are measured using a cost basis or current basis in profit or loss or/and gains and losses arising when the assets are derecognised.

11. These approaches are variations of a cost measurement basis for presentation in profit or loss. Accordingly, the 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 is recognised in OCI.

Staff analysis

12. The staff recommend that in the forthcoming Standard for the disaggregating of changes in market variables between profit or loss and OCI, the IASB should:

    (a) not prescribe detailed mechanics for doing so; and

    (b) rely on the objective that the insurance investment expense should be presented using a cost measurement basis in profit or loss. Accordingly the difference in determining the insurance investment expense using a cost measurement basis and a current measurement basis would be presented in OCI and those amounts reverse.

13. Staff thinks that relying on an objective would avoid the difficulty of specifying the mechanics in a way that is universally applicable for contracts with participation features accounted for under the forthcoming Standard. Those contracts include those that are accounted for under the general approach and variable fee approach. Specifying the mechanics would result in complexity in the requirements because of the variety of contracts in existence and the need to tailor the requirements to the different features of those contracts. In particular, because under the objective changes in the amount of cash flows arising from changes in market variables would be presented consistently with the changes in discount rates (discussed in paragraph 7-9).

14. The staff think that relying on a principle for disaggregating the effects of the market variables will allow entities to determine the appropriate mechanics to present the insurance investment expense using a cost measurement basis in profit or loss based on whether, and how, the amount of cash flows are expected to vary with market variables.

15. Staff thinks that it would reduce the complexity of the requirements if the objective would also apply to contracts *without* participation features. The staff thinks that the objective captures the principle of the previous decisions on such contracts.

16. Some may be concerned that the lack of prescribed mechanics may result in some entities manipulating the amounts presented in profit or loss. The staff thinks that this is unlikely to be the case, because any mechanics used will be constrained by an entity seeking to reduce accounting mismatches between the assets measured at cost in profit or loss. Consequently, any mechanics for the presentation of the insurance investment expenses will follow the cost measurement basis for the asset (eg amortised cost in IFRS 9 *Financial Instruments)*.

17. Accordingly, the staff think that:

    (a) for a contract in which changes in market variables do not affect the nominal amounts paid to the policyholder, presenting the insurance investment expense using the discount rate at the inception of the contract is consistent with a cost measurement basis. The difference between a cost and current measurement basis is recognised in OCI and the amounts reverse over the contract's life.

(b) for a contract in which changes in market variables affect the amounts of some of the cash flows, the entity will need to decide whether the contract is predominately economically similar to a contract in which changes in market variables do or do not affect the nominal amounts paid to policyholder. The entity would need to exercise judgement on the appropriate mechanics to reflect the nature of the cash flows of a particular contract with a participation feature. The staff think that the entity could satisfy the objective of presenting the insurance investment expense using a cost measurement basis by considering the type of cash flows predominant in the reporting period.

(c) for contracts in which changes in market variables are expected to affect the nominal amounts paid to the policyholder in most or all circumstances, presenting the insurance investment expense using a discount rate that reflects the extent to which the effects of changes in market variables affects the existing nominal payments to policyholders is consistent with a cost measurement basis. Consequently, the staff think that for some insurance contracts, an insurance investment expense that uses a discount rate that reflects the explicit crediting rate in the reporting period to the policyholder in the period may be appropriate, because that is a faithful representation of a cost measurement basis. For other insurance contracts, an insurance investment expense using a discount rate that is reset to account for new changes in market variables over the remaining life of the contract may be a more faithful representation of a cost measurement basis.

18. As discussed in Appendix A of Agenda Paper 2A, the mechanics of a presentation of a cost measurement basis could be adjusted to account for any accounting mismatches arising:

(a) when some assets are accounted for using a current measurement and others using a cost measurement bases; and

(b) when there are gains and losses arising when the asset measured at cost in the profit or loss is derecognised.

19. Staff thinks that adjusting the mechanics to address those accounting mismatches, while highlighting economic mismatches in profit or loss, would result in substantial additional complexity in the Standard. In addition, those complex requirements would result in a similar net investment margin, and hence, net profit or loss as presenting an insurance investment expense in profit or loss using a current measurement basis and measuring the items held at fair value through profit or loss. The staff thinks that the benefits of eliminating the accounting mismatches of the type noted in paragraph 18 under a cost measurement objective are outweighed by the costs of the added complexity.

20. However, to address accounting mismatches in other ways:

(a) Agenda Paper 2C considers whether the decisions reached in the paper should be modified for contracts in which economic mismatches do not exist with the items held to eliminate accounting mismatches in profit or loss (ie by application of the current period book yield approach). Such contracts are a subset of contracts accounted for under the variable fee approach.

(b) Agenda Paper 2D considers whether the IASB should allow an entity to choose as its accounting policy to present the insurance investment expense in profit or loss using a current measurement basis.

Question 2: Objective of disaggregating changes arising from changes in market variables

Does the IASB agree, for all contracts, that the forthcoming Standard:

(a) should specify that the objective of disaggregating changes in the insurance contract arising from changes in market variables between profit or loss and OCI is to present an insurance investment expense in profit or loss using a cost measurement basis?
Accordingly, the difference between presenting an insurance investment expense in profit or loss using a cost measurement basis and current measurement basis is recognised in OCI and those amounts reverse.

(b) should not specify detailed mechanics for the determination of the insurance investment expense using a cost measurement basis?