STAFF PAPER

September 2015

IASB Meeting

Project	**Insurance contracts**		
Paper topic	Disaggregating changes arising from changes in market variables in the statement of comprehensive income—Modification of the objective for contracts with no economic mismatches		
CONTACT(S)	Joanna Yeoh	jyeoh@ifrs.org	+44 (0)20 7462 6481

Introduction

1. Agenda Papers 2A–2B for this meeting discuss how the changes for the insurance contract arising from changes in market variables could be disaggregated between profit or loss and other comprehensive income (OCI). In Agenda Paper 2B, staff recommends that when disaggregating changes arising from changes in market variables, the objective should be to present an insurance investment expense in profit or loss using a cost measurement basis.

2. An inherent feature of a cost measurement basis in profit or loss, such as fair value through OCI (FVOCI), is that accounting mismatches are more likely to arise (See Agenda Paper 2A). However, eliminating the accounting mismatches in profit or loss when applying a cost measurement basis in profit or loss could be simpler to achieve when there are no economic mismatches. This paper considers whether the IASB wishes to modify the objective of disaggregating changes in market variables between profit or loss and other comprehensive income for a subset of contracts in which there is no economic mismatch.

3. When there are no economic mismatches, accounting mismatches could be eliminated in profit or loss by presenting an insurance investment expense (or income) that exactly matches the gains or losses presented in profit or loss that arises from the underlying items (hereafter referred to as the current period book yield approach). Consequently, the modified objective, when disaggregating

changes arising from changes in market variables, would be to present an insurance investment expense that eliminates accounting mismatches in profit or loss with items held that are measured using a cost measurement in profit or loss.

4. Economic mismatches do not exist when the entity's obligation to pay the policyholder is affected by 100 per cent of the changes in the fair value of the underlying items. This is the case for direct participation contracts[1] that will apply the variable fee approach[2], provided that the entity holds the underlying items, either by choice or because it is required to.

5. For direct participation contracts, the change in the fair value of the 100 of underlying items promised in the contract is presented in the statement of comprehensive income. Under the current period book yield approach, when the changes in the fair value of the underlying items promised in the contract corresponds to the changes in fair value of the items held for the entire period that the items are held, the entity would disaggregate that change as follows[3]:

    (a) The entity would determine the insurance investment expense (or income) in profit or loss on the insurance contract as equal and opposite in amount to the gain or losses presented in profit or loss for the items held. Accordingly, there is a nil effect on the investment margin.

---

[1] The IASB tentatively decided that contracts with direct participation features should be defined as contracts for which:

(a) the contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items;

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and

(c) a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

[2] Under the variable fee approach, the entity's obligation to the policyholder is considered to be the net of:

(a) the obligation to pay the policyholder an amount equal to the fair value of the investment portfolio (referred to as 'underlying items'). The underlying items are referenced assets, or a pool of assets and liabilities, on which the obligation is based; and

(b) variable fee that the entity deducts in exchange for the services provided by the insurance contract.

[3] In some circumstances, the obligation to pay the policyholder changes in 100 per cent of the fair value of the underlying items is for only a specified period of the item's life but that item is held by the entity for longer period than that specified period. In this limited circumstance and when the item is measured using a cost basis in profit or loss, the entity would need to determine the insurance investment expense that is the equal and opposite of the gains and losses reported in profit or loss for the item held using a cost measurement basis for only that specified period (ie when the changes in the fair value of the item corresponded to the underlying items promised in the contract).

(b) Any difference between the insurance investment expense (or income) presented in profit or loss and the change in the insurance contract recognised in the statement of comprehensive income (ie the total change in the fair value of the underlying items) would be presented in OCI.

6. Accordingly, only a subset of direct participation contracts applying the variable fee approach could apply the modified objective for disaggregating changes in the insurance contract between profit or loss and OCI (ie those where the entity holds the underlying items). Contracts applying the variable fee approach in which economic mismatches exist would need to apply an approach that meets the objective discussed in Agenda Paper 2B and hence, apply an effective yield approach.

7. This paper considers whether the objective for disaggregating changes arising from changes in market variables should be modified for contracts in which economic mismatches does not exist in paragraphs 22-25.

8. To inform that discussion, the paper first considers what requirements an entity should apply when the current period book yield approach is changed to an effective yield approach (and vice versa) in paragraphs 9-21.

Requirements for direct participation contracts that no longer qualify for the current period book yield or newly qualify for the current period book yield

9. In paragraphs 22-25, the staff will ask the IASB to consider if the objective for disaggregating changes arising from changes in market variables between profit or loss or OCI should be modified for contracts where there are no economic mismatches. That modification would mean that the insurance investment expense would be determined using:

   (a) the current period book yield, when there are no economic mismatches with the items held; and

   (b) the effective yield approach, when there are economic mismatches.

10. The staff note that if the IASB decides to modify the objective as described in paragraph 9, the IASB would need to develop requirements to address changing between the approaches. In particular, the IASB would need to consider:

    (a) How should the accumulated balance of OCI be accounted for when moving between the effective yield approach and the current period book yield approach? This is discussed in paragraphs 12-18.

    (b) Should the entity restate the comparative period information? This is discussed in paragraph 19.

    (c) What disclosures should apply? This is discussed in paragraph 20-21.

    Those questions arise for both situations in which (1) the entity qualifies for the current period book yield in one period but not in the following period (2) the entity does not qualify for the current period book yield in one period but qualifies in the following period. Consequently, the following section discusses those questions for both situations.

11. Staff thinks that these additional requirements would need to be specified because without them, the entity could choose between potential different approaches, which would result in lack of comparability.

How should the accumulated balance of OCI be accounted for when moving between the approaches?

Restating the accumulated balance of OCI

12. When an entity no longer qualifies for the current period book yield or newly qualifies for the current period book yield, there may be an amount in the accumulated balance of OCI on the date of change. Should the accumulated balance of OCI be restated as if the approach applicable in the reporting period had been applied since the initial recognition of the contract? For example, if the entity newly applied the effective yield approach in the period, should the accumulated balance of OCI be restated as if the entity had applied the effective yield approach from the date when the contract was initially recognised. If so, the difference between the restated accumulated balance and the accumulated balance of OCI prior to the change would be recognised in equity consistent with retrospective application of new accounting requirements.

13. However, the staff do not think the accumulated balance of OCI should be restated as if the approach that is applicable for that reporting period had been applied since the date when the contract was initially recognised. Because each approach is applied in situations that are appropriate to that approach, it would be more representationally faithful to present the prior periods using the approach that applied in the prior periods. Restating the accumulated balance of OCI would not reflect that, in the prior periods, the contracts qualified for a different approach to disaggregating the changes in the fair value of underlying items.

14. In addition, the staff think that in most cases, restating the accumulated balance of OCI would be difficult to do, because of the lack of historical information available. Simplifications would have to be provided if the IASB were to require the restatement of the accumulated balance of OCI.

Recognition of the accumulated balance of OCI on the date of transfer

15. The staff recommend that the accumulated balance of OCI should not be restated as if the applicable approach in the reporting period had been applied since the inception of the contract. Consequently, there may be circumstances in which there is an accumulated balance in OCI on the date of the change to a different

approach. There are three alternatives for subsequent accounting for that accumulated balance in OCI:

(a) Recognise those accumulated gains or losses in profit or loss in the period of the change and future periods. The accumulated gains and losses could be recognised in OCI in the current and future periods accordingly:

(i) when the entity had previously been applying the effective yield approach, the entity could determine an effective interest yield approach going forward using the same assumptions that applied prior to the change.

(ii) when the entity had previously been applying the current period book yield, the entity could continue to recognise the accumulated OCI using the same assumptions that applied prior to the change.

(b) Recognise those accumulated gains or losses in profit or loss immediately in the period of the change, if those gains or losses would have been recognised in profit or loss in future periods if the change did not occur.

(c) Not to recognise those accumulated gains and losses in profit or loss in the period of the change or in future periods. In other words, the accumulated gains and losses remain in equity. The entity may transfer those gains and losses to another component of equity.

16. The arguments for each of the three approaches are:

(a) the gains and losses accumulated in OCI should be recognised in profit or loss in the period of the change and in future periods in a manner that is consistent with the assumptions made when recognising those gains and losses in OCI in the first place. This could be regarded as consistent with the recognition of those gains and losses in OCI in the first place.

(b) the change in approach for the determination of investment insurance expense is analogous to a change in an accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting*

Estimates and Errors (IAS 8). Consequently, those accumulated gains or losses should be recognised in profit or loss in the period of the change, if those gains or losses would have been recognised in profit or loss in future periods if the change did not occur

(c) the amounts accumulated in OCI under a prior approach is relevant only to that prior approach, not in any period under the new approach. In addition, recognising those gains and losses in profit or loss when another approach is deemed appropriate may produce results that would be difficult to explain (ie either recognising those accumulated gains or losses in period of the change or in the period of the change and future periods). A change in the mechanics of the determination of investment insurance expense, which in their view is analogous to a change in accounting policy.

> The following are the relevant IAS 8 definitions:
>
> *Accounting policies* are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
>
> A *change in accounting estimate* is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

17. Some note that the alternative of never recognising the accumulated balance of OCI for the liability in profit or loss (ie in paragraph 16(c) prior to the change in approaches is inconsistent with the rebuttable presumption in the IASB's Exposure Draft *Conceptual Framework for Financial Reporting* that gains and losses recognised in OCI should eventually be recognised in profit or loss).

18. On balance, staff is persuaded by the arguments for **not** recognising those gains and losses in profit or loss. Staff thinks that this is consistent with the rationale for not restating the accumulated balance of OCI in paragraph 13.

Comparative period information

19. When an entity changes from one approach to the other, the staff think that, because each approach is applied in situations that are appropriate to that approach, it would be more representationally faithful to present the prior periods using the approach that applied in the prior periods. Restating information would not reflect that in the prior period, the contracts qualified for a different approach to disaggregating the changes in the fair value of underlying items. This is consistent with the staff recommendation **not** to restate the accumulated balance in OCI using the newly applicable approach as if that approach had been applied from the date when the contract was initially recognised, as discussed in paragraph 13.

Disclosures

20. The staff think that additional disclosures should be required when the entity changes from the current period book yield approach to the effective yield approach (and vice versa), because there is a significant effect on the amounts recognised in profit or loss and OCI. That is, there is a difference in the amounts recognised in profit or loss and OCI between the prior period and the reporting period in which the change happened.

21. Accordingly the staff propose that, when an entity is required to change the approach used to determine insurance investment expense, the entity should disclose:

    (a) An explanation of:

        (i) the reason for the change; and

        (ii) the effect of the change on each financial statement line item affected; and

    (b) the value of the contracts that no longer qualified for the current period book yield but previously qualified (and vice versa).

Modifying the objective for the disaggregating changes in the insurance contract resulting from changes in market variables between profit or loss and OCI

22. In Agenda Paper 2B, staff recommend that when disaggregating changes arising from changes in market variables, the objective should be to present an insurance investment expense in profit or loss using a cost measurement basis. An inherent feature of a cost measurement basis in profit or loss is that accounting mismatches are likely to arise. As discussed in paragraphs 2-6, when there are no economic mismatches, it could be relatively simple to eliminate accounting mismatches in profit or loss. Economic mismatches would not exist for some direct participation contracts that apply the variable fee approach.

23. This section considers whether the IASB should modify the objective of the presenting the insurance investment expense in profit or loss using a cost measurement basis to eliminating accounting mismatches with items held that are measured using a cost measurement in profit or loss. If so, entities would be *required* to apply the current period book yield approach when disaggregating changes in market variables between profit or loss and OCI.

24. The arguments against modifying the objective for the presentation of the insurance investment expense when disaggregating changes in market variables are as follows.

    (a) The main argument against the use of the current period book yield approach is that doing so would introduce additional complexity in the Standard as a whole. This is because there will be two approaches to disaggregating changes in market variables between profit or loss and OCI. The current period book yield approach's primary objective is to address accounting mismatch in profit or loss. Its secondary objective is to present a cost measurement basis in profit or loss. In contrast, the effective yield approach's objective is solely to present a cost based measurement basis in profit or loss.

    (b) The current book yield approach also introduces complexity into the requirements because the IASB would need to specify requirements to address situations in which there is an economic match in some periods but not in others. For example, the entity holds the underlying items in some periods but not in others. This is discussed in paragraphs 9-21.

(c) The current period book yield approach would introduce in IFRS a requirement to eliminate accounting mismatches for items measured at cost in profit or loss. Under existing IFRS, an entity can fully eliminate accounting mismatches only for items accounted for at fair value through profit or loss (FVPL).

(d) Some think that the complexity of the current period book yield is unnecessary, because a simpler way of achieving the modified objective of eliminating accounting mismatches in profit or loss is to measure the items held at FVPL and to present an insurance investment expense using a current measurement basis. They note that doing so results in the same net effect in profit or loss as using the current period book yield for the insurance contract and a cost measurement basis in profit or loss for the items held. That is that there is a nil effect on the investment margin.

25. Arguments for modifying the objective for the presentation of the insurance investment expense when disaggregating changes in market variables to eliminate accounting mismatch in profit or loss are as follows:

(a) The current period book yield approach results in more complete reduction in accounting mismatches in profit or loss compared to presenting the insurance investment expense using a cost measurement basis. Accordingly, the current period book yield approach would enhance the relevance of the information in profit or loss for the period.[4] When direct participation contracts qualify for the current book yield approach, there is no possibility of economic mismatch.

[4] Paragraph 7.24 of the Exposure Draft *Conceptual Framework for Financial Reporting* states that the presumption that all income and all expenses will be included in the statement of comprehensive income can be rebutted ‘only if:

(a) the income or expenses (or components of them) relate to assets or liabilities measured at current values….; and

(b) excluding those income or expenses (or components of them) from the statement of profit or loss should enhance the relevance of the information in that statement for the period’.

Consequently, for those contracts it would be appropriate to eliminate accounting mismatches in profit or loss.

(b) Those that support the current period book yield agree that it is a new approach and therefore additional requirements would be needed (ie when the entity is changing between the approaches as discussed in in paragraphs 9-21). However, they think the benefits, discussed in paragraph (a), outweigh the costs of specifying these additional requirements.

(c) While measuring all the assets at fair value through profit or loss would also resolve the accounting mismatch, some argue that some assets or liabilities are not permitted to be measured at FVPL under IFRS (eg intangible assets). In addition, the feedback received from constituents is that measuring assets at fair value through profit or loss would reduce comparability with other financial institutions. That comparability can only be achieved by measuring the assets using a cost measurement basis in profit or loss when that is the preferred measurement basis in the relevant IFRS.

Questions for the IASB

Question 1: Modification to the objective for disaggregating changes in market variables between profit or loss and OCI (paragraphs 22-25)
When there is no economic mismatches between the insurance contract and the items held, does the IASB wish to modify the objective of disaggregating changes in market variables between profit or loss and OCI to present the insurance investment expense that eliminates accounting mismatches in profit or loss with items held that are measured using a cost measurement basis in profit or loss? Accordingly the difference between the changes in the contract arising from changes in market variables (ie changes in the fair value of the underlying items) and the insurance investment expense in recognised in OCI. Economic mismatches do not exist when: (a) the contract is a direct participation contract (ie the entity has an obligation to pay the policyholders the fair value of the underlying items and therefore, applies the variable fee approach.); and (b) the entity holds the underlying items, either by choice or because it is required to.

Question 2: Changing approaches (paragraphs 9-21)
If the IASB has decided to modify the objective of disaggregating changes in market variables between profit or loss and OCI for contracts in which economic mismatches do not exist, does the IASB agree that if an entity is required to change between the effective yield approach and the current book yield approach (and vice versa), the entity shall: (a) *not* restate the opening accumulated balance of OCI; (b) *not* recognise in profit or loss the accumulated balance of OCI on the date of the change or in future periods (ie that the accumulated balance of OCI remains in equity); (b) *not* restate prior period comparatives; and

(c) disclose, in the period that the change in approach occurred:

(i) an explanation of:

(1) the reason for the change; and

(2) the effect of the change on each financial statement line item affected; and

(ii) the value of the contracts that no longer qualified for the current period book yield but previously qualified (and vice versa)?