STAFF PAPER

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IASB Meeting

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

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Introduction

1. Agenda Papers 2A–2C for this meeting discuss how the changes in the insurance contract arising from changes in market variables could be disaggregated between profit or loss and other comprehensive income (OCI).

2. This paper considers, for contracts with participation features, two other issues regarding the disaggregation of changes resulting from changes in market variables between profit or loss and OCI, as follows:

   (a) when to disaggregate changes in the insurance contract between profit or loss and OCI, ie whether to extend to contracts with participation features the accounting policy choice to present the insurance investment expense in profit or loss using either a cost measurement basis or a current measurement basis. This is discussed in paragraphs 7–14.

   (b) simplified requirements for the determination of the insurance investment expense using a cost measurement basis for the insurance contract that could apply when the entity applies the requirements for the first time (transition). Such simplifications may be needed because an entity that chooses as its accounting policy choice to disaggregate changes in market variables between profit or loss and OCI would be required to determine the insurance investment expense reflecting a cost measurement basis (and accumulated balance of OCI) retrospectively, if practicable. Hence, the question arises of what to do if this is not practicable. This is discussed in paragraphs 15–34.

3. This paper is predicated on the IASB answering 'Yes' to the questions posed in Agenda Paper 2B.

Staff recommendations

Accounting policy choice (paragraphs 7–14)

4. The staff recommend that the IASB should extend to contracts with participating features its previous decisions for contracts *without* participation features that an entity should:

   (a) choose, as its accounting policy, either:

      (i) to disaggregate changes in market variables between profit or loss and OCI by presenting an insurance investment expense in profit or loss using a cost measurement basis. Accordingly, the difference in the insurance investment expense presented using a cost measurement basis and a current measurement basis is presented in OCI.

      (ii) to present the insurance investment expense in profit or loss using a current measurement basis.

   (b) apply that accounting policy to groups of similar contracts, taking into consideration the portfolio in which the contracts are included, the assets that the entity holds and how those assets are accounted for; and

   (c) apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to any changes in that accounting policy.

5. The staff recommend that, if the IASB decides in Agenda Paper 2C to modify the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI when there are no economic mismatches between the insurance contract and the items held, an entity should instead choose as its accounting policy either:

(a) to disaggregate changes in market variables between profit or loss and OCI by presenting an insurance investment expense in profit or loss using that modified objective. The difference in the insurance investment expense presented using that modified objective and a current measurement basis is presented in OCI; or

(b) to present the insurance investment expense in profit or loss using a current measurement basis.

Simplified approach for the determination of the accumulated balance of OCI on transition to the new insurance contracts Standard (paragraphs 15-34)

6. When retrospective application on first application of the new insurance contracts standard is impracticable, the staff recommend that the IASB simplify the approach for determining the insurance investment expense (and accumulated balance of OCI) for contracts in which changes in market variables affects the amount of cash flows, as follows:

   (a) For contracts for which the objective is to present an insurance investment expense using cost measurement basis in profit or loss (ie those applying an effective yield approach), an entity should assume that the earliest market variable assumptions that should be considered for the insurance investment expense using a cost measurement basis are those that occur when the entity first applies the new Standard. Accordingly, on the date when the entity first applies the new Standard, the accumulated balance in OCI for the insurance contract is zero.

   (b) If the IASB decides in Agenda Paper 2C to modify the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI, an entity applying the current period book yield approach should assume that the insurance investment expense (or income) is equal and opposite in amount to the gain (or losses) presented in profit or loss for the items held by the entity. Accordingly, an entity should assume that the accumulated balance of OCI is determined as follows:

(i) when the items held are measured at fair value through profit or loss (FVPL), there would be no amounts accumulated in OCI; and

(ii) when the items held are measured at cost in profit or loss, the accumulated balance of OCI for the insurance contracts would be the difference between the items measured at cost and their fair value.

Accounting policy choice

7. For contracts *without* participation features, the IASB has decided that an entity should choose as its accounting policy to present the insurance investment expense in profit or loss using a cost or current measurement basis. Paragraphs 8–10 set out the IASB's considerations for doing so. Paragraphs 11–14 consider whether that accounting policy choice should be extended to contracts with participation features.

Background for contracts without participation features

8. For contracts *without* participation features, the IASB has decided to allow an entity to choose as its accounting policy choice whether to:
   (a) present an insurance investment expense in profit or loss using a current measurement basis; or
   (b) disaggregate changes in market variables between profit or loss and OCI by presenting an insurance investment expense in profit or loss using a cost measurement basis.

9. In reaching this conclusion, the IASB sought to balance the sometimes competing demands of understandability and comparability by adopting an approach that:
   (a) acknowledges that it could be appropriate to disaggregate changes in market variables between profit or loss and OCI by presenting the investment insurance expense using a cost measurement basis.
   (b) acknowledges that an inherent feature of a cost measurement basis in profit or loss is that accounting mismatches are likely to arise, and hence allows entities to avoid such mismatches by permitting entities to present the insurance investment expense using a current measurement basis (ie using current rates).
   (c) also allows entities to avoid the costs and complexity of using OCI when the benefits of doing so do not outweigh those costs (because permitting entities to present insurance investment expense using the current rate in profit or loss would eliminate the need for additional calculations to derive separate amounts in profit or loss and OCI).

10. The IASB noted that, in selecting an accounting policy, entities would need to apply judgement regarding the relative benefits and costs.

Staff analysis

11. The staff think that the IASB's rationale for an accounting policy choice for a portfolio of contracts *without* participation features is also applicable to a portfolio of contracts with participation features. The rationale is that an accounting policy choice:

    (a) acknowledges that it could be appropriate to disaggregate changes in market variables between profit or loss and OCI by presenting the investment insurance expense using a cost measurement basis in profit or loss.

    (b) allows entities to avoid accounting mismatches in profit or loss by presenting the investment insurance expense using a current measurement basis. Accordingly, an entity is able to measure assets at FVPL. However, the staff observes that if the IASB modifies the objective of disaggregating changes in market variables between profit or loss and OCI as discussed in Agenda Paper 2C, this reasoning would not be applicable. This is because the modified objective already eliminates accounting mismatches in profit or loss with the items held.

    (c) allows entities to avoid the costs and complexity of presenting an insurance investment expense when the benefits of doing so do not outweigh the costs. Those costs and complexities are:

        (i) for contracts applying the objective of presenting the insurance investment expense in profit or loss using a cost measurement basis, the entity would need to do additional calculations to determine the amounts presented in profit or loss and OCI.

        (ii) for contracts applying the current book yield approach, the approach may first appear to be less complex because the amounts are determined by the gains and losses in profit or loss arising from the item held. However, there are additional complexities that arise when the entity changes between the current book yield approach and the effective yield approach as discussed in Agenda Paper 2C.

12. Accordingly, the staff recommend that the IASB should extend the accounting policy choice to present the insurance investment expense in profit or loss on either a cost measurement basis or a current measurement basis to contracts with participation features.

13. To be consistent with the IASB's decisions for contracts *without* participation features, the following should also apply to the selection of the accounting policy choice:

    (a) an entity should apply that accounting policy choice to groups of similar contracts, taking into consideration the portfolio in which the contract is included, the assets that the entity holds and how those assets are accounted for; and

    (b) if the entity were to change its accounting policy subsequently, then it should apply the requirements in IAS 8 to changes in accounting policy relating to the presentation of the changes in the liability arising from the changes in the fair value of the underlying item.

14. The staff intend to consider the relevant disclosures that should be required at a future meeting.

Questions 1 & 2—Accounting policy choice

1. Does the IASB agree that it should extend to contracts with participating features its previous decisions for contracts *without* participation features that an entity shall:

(a) choose, as its accounting policy, either:

 (i) to disaggregate changes in market variables between profit or loss and OCI by presenting an insurance investment expense in profit or loss using a cost measurement basis. Accordingly, the difference in the insurance investment expense presented using a cost measurement basis or a current measurement basis is presented in OCI.

 (ii) to present the insurance investment expense in profit or loss using a current measurement basis.

(b) apply that accounting policy to groups of similar contracts, taking into consideration the portfolio in which the contracts are included, the assets that the entity holds and how those assets are accounted for; and

(c) apply the requirements in IAS 8 to any changes in that accounting policy?

2. If, in Agenda Paper 2C, the IASB decides to modify the objective of disaggregating changes in market variables between profit or loss and OCI when there are no economic mismatches between the insurance contract and the items held, does the IASB agree an entity should instead choose as its accounting policy either:

(a) to disaggregate changes in market variables between profit or loss and OCI by presenting an insurance investment expense using that modified objective. The difference in the insurance investment expense presented using that modified objective and a current measurement basis is presented in OCI.

(b) to present the insurance investment expense in profit or loss using a current measurement basis?

Simplified approach to the determination of the accumulated balance of OCI on transition to the new insurance contracts Standard

15. This section discusses how, on transition to the new insurance contracts Standard, an entity that presents insurance investment expense using a cost measurement basis should determine that insurance investment expense (and the accumulated balance of OCI) for contracts in which changes in market variables affect the amount of cash flows and those cash flows are the predominant type of cash flows. Such contracts include most contracts with participation features[1]. The discussion is divided as follows:

    (a) paragraphs 17–20 provide background on the IASB's relevant considerations for contracts *without* participation features; and

    (b) paragraphs 21–34 discuss whether further simplifications should be provided for contracts in which changes in market variables affect the amount of cash flows, when retrospective application is impracticable.

16. The simplified transition requirements are only relevant to an entity that chooses as its accounting policy to disaggregate changes in market variables between profit or loss and OCI for a portfolio of insurance contracts. For entities applying that accounting policy retrospectively, historical information is needed to present an insurance investment expense using a cost measurement basis in profit or loss. Historical information is not needed for an entity that chooses as its accounting policy to present insurance investment expense using a current measurement basis.

Background

17. The IASB proposes that an entity should retrospectively measure and present insurance contracts when an entity first applies the new Standard, if practicable.

[1] For the few contracts with participation features in which the predominant type of cash flows are those whose amounts are not affected by changes in market variables, the appropriate effective yield approach to present the insurance investment expense in profit or loss using a cost measurement basis could be the approach applicable to contracts *without* participation features, ie paragraphs 19-20 apply.

18. The fulfilment cash flows is measured using a current measurement basis and therefore does not require the use of historical data. However, historical data is required to determine retrospectively:

    (a) the contractual service margin.

    (b) the measurement of revenue.

    (c) the insurance investment expense recognised in profit or loss, if an entity has chosen as its accounting policy to disaggregate changes in market variables between profit or loss and OCI by presenting the insurance investment expense using a cost measurement basis in profit or loss.

Contracts without participation features

19. For contracts *without* participation features (ie contracts in which changes in market variables do not affect the amount of cash flows), the insurance investment expense and the accumulated balance in OCI will be determined using the discount rate at the date of initial recognition of the contract.

20. For such contracts, the IASB has concluded that:

    (a) when determining that the discount rate at initial recognition retrospectively is impracticable, entities should always be able to estimate the discount rate to use, using the method in the proposed simplified approach in paragraphs C6(c)–(d) of the Exposure Draft *Insurance Contracts*, which was published in 2013 (‘the 2013 ED’). This would mean that the entity estimates the discount rate at the date of initial recognition either:

        (i) by reference to an observable yield curve that approximates the yield curve of the insurance contract during the three years before the beginning of the earliest period presented.

        (ii) if there is no such observable yield curve, by applying an average spread between an observable yield curve and the yield curve of the insurance contract. The spread should be determined as an average over at least three years before the beginning of the earliest period presented.

(b) accordingly, when the entity chooses as its accounting policy to disaggregate changes in market variables between profit or loss and OCI, the entity should estimate the discount rate at the date of initial recognition using the method in the proposed simplified approach in paragraphs C6(c)–(d) of the 2013 ED.

Contracts in which changes in market variables affects the amount of cash flows

21. Agenda Papers 2B–2C consider approaches to disaggregating the changes in market variables for contracts with participation features, as follows:

    (a) when the objective for disaggregating the changes arising from changes in market variables is to present insurance investment expense in profit or loss using a cost measurement basis, the version of the effective yield approach that is most suited to the features of the contract would satisfy this objective. Additional simplified transition requirements for the effective yield approaches are considered in paragraphs 22–29.

    (b) if the IASB modifies the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI as described in Agenda Paper 2C, the current period book yield would satisfy that modified objective. Additional simplified transitional requirements for the current book yield are considered in paragraphs 30–34.

Effective yield approach applicable to contracts with participation features

22. As discussed in Agenda Paper 2B, examples of the effective yield approach mechanics that an entity could apply are the following:

    (a) 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; or

    (b) 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.

23. More historical data is required to determine the insurance investment expense (and accumulated balance of OCI) for contracts in which changes in market variables affect the amount of cash flows, than for contracts in which market variables do not affect the amounts of cash flow (ie *without* participation features). For contracts *without* participation features, changes in market variables result only in changes in discount rates. Accordingly, the amounts recognised in the accumulated balance of OCI reflect the disaggregated changes in discount rates. In contrast, for the majority of contracts with participation features, changes in market variables result in changes to both discount rates and nominal cash flows. Accordingly, the amounts recognised in the accumulated balance of OCI reflect the disaggregated changes in both discount rates and cash flows. This was discussed in Agenda Paper 2A.

24. For contracts in which changes in market variables affect the amount of cash flows, the insurance investment expense that would have been recognised had the insurance standard been applied from the inception of the contract is determined by:

    (a) estimating the cash flows amounts affected by changes in market variables for each period since the contract was incepted, which may include the explicit crediting rate where relevant; and

    (b) estimating the insurance investment expense that would have been recognised in each prior period by considering the effects of market variables (both cash flows and discount rates) accumulated in the beginning of each relevant period and when the period in which those effects were expected to self-reverse. Under both the effective yield approaches discussed in paragraph 22, the rate used to calculate the insurance investment expense is recalculated at every period that effectively spreads the recognition of those amounts over the period in which those changes are expected to reverse.

25. Consequently, the staff think that it is difficult to provide a simplification that approximates the results that would have been achieved if retrospective application was possible. The staff considered two possible simplifications:

(a) the simplification provided for contracts *without* participation features, as discussed in paragraph 19; that is, applying the discount rate at inception to the cash flows existing at transition.

(b) a simplification that assumes that the earliest market variable assumptions that is considered for the insurance investment expense using a cost measurement basis are those that occur when the entity first applies the new Standard. Accordingly, on the date when the entity first applies the new Standard, the accumulated balance in OCI for the insurance contract is zero.

26. The staff think that both alternatives discussed in paragraph 25 are unlikely to result in an approximation of the accumulated balance of OCI resulting from the retrospective application of the requirements. If retrospective application is possible, then the accumulated balance of OCI is likely to be a debit balance on transition.[2] The staff note that:

(a) if the simplification provided for contracts *without* participation were to be applied, then it would result in a significantly different accumulated balance of OCI than the balance determined retrospectively, because the applicable effective yield approaches would have recognised some of those amounts in periods prior to the first application of the Standard. Hence, the insurance investment expense in the period of transition and in future periods would be different than if the retrospective application were to be applied.

(b) if the simplification provided is to assume that the accumulated balance of OCI on transition is zero, that is likely to be less than the debit balance that would arise from retrospective application This is likely to result in a positive investment margin that is larger than if the requirements were applied retrospectively. The larger positive margin results from:

[2] Accumulated OCI is likely to be a debit balance because interest rates are likely to be lower now than at inception of the contract. Hence the amount of insurance investment expense determined on a cost basis is likely to be more than the insurance investment expense determined on a current measurement basis, and hence the accumulated amount recognised in OCI is likely to be a debit balance.

(i) if the assets held, particularly financial assets, are measured using a cost basis in profit or loss, the investment income of the assets reflects the interest rates at the time at which those assets were purchased/originated. Those rates are likely to be higher than the current interest rates because of the effects of the global financial crisis.

(ii) presenting an insurance investment expense using a cost measurement basis in profit or loss that is based on the market variables (eg interest rates) at transition. Those rates are likely to be significantly lower than the interest rates present when the assets were purchased or originated and those assets are measured using a cost basis in profit or loss.

In addition, under this alternative the accumulated balance of OCI is assumed to be zero, which is likely to be significantly different to the accumulated balance of OCI determined retrospectively, which is likely to be a debit balance.

27. Both alternatives are unlikely to be a close approximation of the accumulated balance of OCI determined retrospectively. Accordingly, the staff recommend the less costly alternative, which is to assume that the accumulated balance of OCI on transition is zero. An entity would then disaggregate changes in market variables that occur after the transition date between profit or loss and OCI in future periods.

28. The staff will consider in future whether there should be additional disclosures to allow users of financial statements to analyse the investment margin.

29. Some may consider that the simplification of assuming that the earliest market variable assumptions that should be considered for the investment expense using a cost measurement basis are those that occur when the entity first applies the new Standard, and hence, the accumulated balance of OCI is zero, results in a misleading view of performance. If so, an alternative is to require an entity to present an insurance investment expense using a current measurement basis for contracts with participation features, when retrospective application of the accumulated balance of OCI is impracticable. However, doing so is not consistent

with the IASB's rationale for allowing an accounting policy choice for disaggregating changes in market variables between profit or loss and OCI.

Current period book yield

30. If the IASB were to tentatively decide 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, then the entity would apply the current period book yield approach to such contracts. That approach would disaggregate the changes in market variables for the insurance contract by presenting:

(a) in profit or loss, the insurance investment expense (or income) that eliminates in profit or loss any accounting mismatches arising from gains and losses recognised from the item held; and

(b) in OCI, the difference between the total change in the fair value of the underlying item and the insurance investment expense (or income) in profit or loss.

31. Those amounts would not require using historical data, because they are calculated using the information from the current period.

32. However, historical data may be needed to determine the insurance investment expense (and accumulated balance of OCI) in the specific circumstances in which:

(a) the obligation to pay the policyholder changes in 100 per cent of the fair value of the underlying items is only for a specified period of the item's life;

(b) the item is held for a longer period than that specified period; and

(c) the item held is presented in profit or loss using a cost measurement basis.

In this limited circumstance, historical data is needed to reflect the insurance investment expense that is the equal and opposite of the gains and losses reported in profit or loss for the item held. Those gains and losses would reflect a cost measurement basis for only the specified period when the changes in the fair value of the item corresponds to the underlying items promised in the contract.

33. When the determination of the insurance investment expense (or income) (and the accumulated balance of OCI) using the current period book yield is impracticable, the staff propose that the IASB should provide a simplification to enable entities to approximate the insurance investment expense (or income) by requiring that an entity shall assume that the insurance investment expense (or income) is equal and opposite to the amount to the gain (or losses) presented in profit or loss for the items held.

34. Accordingly the accumulated balance of OCI for insurance contracts is determined, as follows:

    (a) when the items held are measured at FVPL, there would be no amounts accumulated in OCI; and

    (b) when the items held are measured at cost in profit or loss, the accumulated balance of OCI for the insurance contracts would be the difference between the underlying items measured at cost and their fair value.

Question 3—Simplified transition requirements for the accumulated balance of OCI

When retrospective application on first application of the new insurance contracts standard is impracticable, does the IASB agree to simplify the approach for determining the insurance investment expense (and accumulated balance of OCI) for contracts in which changes in market variables affects the amount of cash flows, as follows:

(a) for contracts for which the objective is to present an insurance investment expense using a cost measurement basis in profit or loss (ie those applying an effective yield approach), that an entity shall assume that the earliest market variable assumptions that should be considered for the investment expense using a cost measurement basis are those that occur when the entity first applies the new Standard.
Accordingly, on the date when the entity first applies the new Standard, the accumulated balance in OCI for the insurance contract is zero.

(b) If the IASB decides in Agenda Paper 2C to modify the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI, an entity applying the current period book yield approach should assume that the insurance investment expense (or income) is equal and opposite in amount to the gain (or losses) presented in profit or loss for the items held by the entity.
Accordingly, an entity should assume that the accumulated balance of OCI is determined as follows:
(i) when the items held are measured at FVPL, there would be no amounts accumulated in OCI; and
(ii) when the items held are measured at cost in profit or loss, the accumulated balance of OCI for the insurance contracts would be the difference between the items held measured at cost and their fair value.