Another step closer to finalising IFRS 4 Phase II

More education on participating contracts while IFRS 9 is issued in final text

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Agenda

- Highlights of decisions from IASB meeting this month
- IASB staff recommendations and Board discussions
- Next steps and update on timetable

Highlights of decisions from IASB meeting this month

- **IASB meeting on 22 July 2014**
- **Educational session – participating contracts**
  - Two new methods for the presentation of interest expense and their application to different types of cash flows
  - Use of an effective interest rate (EIR) method as a possible method for P&L presentation
- **Contracts without participating features**
  - The locked-in rate must be used to accrete interest on the CSM and to calculate the present value of cash flows that unlock the CSM
- **Changes in accounting policy for the OCI solution**
  - No additional guidance will developed
  - Retrospective application required in all cases unless impracticable
- **IFRS 9 is out, effective on 1 January 2018**

Educational session – Participating contracts

Approach for determining interest expense when the OCI Solution is adopted

Issue

- The presentation of interest expense in profit or loss when the “OCI solution” is assumed to be adopted for participating contracts
- The IASB discussed a method other than the book yield approach previously discussed
- The staff proposed an approach in which:
  - The discount rate should be reset for *all* the cash flows in the contract when the cash flows that vary with the underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract.
  - The rate should be reset whenever there are changes in the estimates of amounts paid to policyholders; and
  - The discount rate used for the presentation of interest expense in profit or loss should be determined using an approach similar to the EIR method for floating rate financial instruments

Educational session – Participating contracts

Approach for determining interest expense when the OCI Solution is adopted

Staff analysis – splitting of cash flows

- The time value of money of asset dependent cash flows is different compared with those that are fixed or non-asset dependent.
- Interest expense should be determined using locked-in discount rates for the latter group of cash flows and a reset locked-in rate for the former group of cash flows
- This is complex and costly. The significant judgment inherent in determining which cash flows should be discounted using locked-in or reset rates could undermine the usefulness of the information provided in terms of comparability.
- The staff proposed that any requirements to update discount rates should apply to *all* cash flows. There would therefore be no need to split the cash flows for presentation purposes as proposed in the 2013 ED.
- The discount rate should be reset for all cash flows when the cash flows that vary with underlying items are likely to be a substantial proportion of the total benefits. Where this is not the case, the locked-in discount rate should be applied to all cash flows.

Educational session – Participating contracts

Approach for determining interest expense when the OCI Solution is adopted

Staff analysis – rate reset methods

- Under the 2013 ED proposals entities are likely to need to construct a yield curve that applies an appropriate discount rate at every reporting period.
- An alternative approach is to use discount rates determined using the EIR method.
- The yield curve is a simpler approach.
- However, the EIR approach would further reduce the accounting mismatch in profit or loss when the return from underlying items is also presented in profit or loss using amortised cost (e.g. for FVOCI and Amortised Cost debt instruments).

Educational session – Participating contracts

Approach for determining interest expense when the OCI Solution is adopted

Staff comments and IASB discussion

- Members were generally supportive of developing an approach based on the EIR method.
- The salient points from the discussion are:
  - The two approaches need to be better understood relative to each other before the IASB decides on which approach to adopt (including the book yield approach)
  - Whether or not there was the need for a bright line for the underlying items to be a "substantial proportion" of the total benefits to the policyholder.
  - The EIR method could be extended to all insurance contracts, but the staff were asking for tentative direction as it may be too soon to decide on this until a decision is reached on participating contracts.
- The IASB decided to have its decision making session on this matter by considering all three alternative approaches: a) book yield approach b) locked-in reset rate and c) EIR method

Contracts without participating features

Rate used to accrete interest and calculate the PV of cash flows that unlock the CSM

Issue

- Whether the rate used to accrete interest on the CSM balance should be:
  - the current rate that is used to measure the insurance contract at the reporting date, or
  - the locked-in rate that was used to determine the CSM at initial recognition

Staff analysis – accretion of interest

- The 2013 ED proposed that the locked-in rate at inception should be used to accrete interest on the CSM.
- It had been suggested that a current rate should be used, to be consistent with all the other components of the insurance contract measurement
- The locked-in rate is conceptually correct and would result in more useful information because of the separation of underwriting and investment results
- An accounting policy choice over which rate to use should not be available

Contracts without participating features

Rate used to accrete interest and calculate the PV of cash flows that unlock the CSM

Staff analysis – Unlocking the CSM

- The 2013 ED proposed that
  (1) the CSM would be adjusted for changes in the PV of cash flows
  (2) the effect of changes in the discount rate should not be offset against the CSM
  (3) the PV of cash flows that unlock the CSM should be calculated using the rate at inception, and
  (4) the effects of changes in discount rates on the insurance contract liability would be presented in OCI.
- Some respondents to the 2013 ED disagreed that the locked-in rate should be used to determine the PV of cash flows that is offset against the CSM because:
  - the costs of tracking the locked-in rate would not be justified; and
  - the current rate would better reflect the change in economic cost.

Contracts without participating features

Rate used to accrete interest and calculate the PV of cash flows that unlock the CSM

Staff analysis – Unlocking the CSM

- The separation between underwriting and investment results is a core benefit of the IASB's model.
- If current rates were used to unlock the CSM
  - some changes in discount rate would be reported in the underwriting result through the release of the CSM
  - changes that should be treated as investment results would no be part of it
  - the cumulative OCI under an OCI accounting policy would be more difficult to explain and calculate

Contracts without participating features

Rate used to accrete interest and calculate the PV of cash flows that unlock the CSM

Staff recommendation

- The locked-in rate at inception of the contract should be used for accreting interest on the CSM and for calculating the change in the PV of expected cash flows that offsets that margin (as proposed in the 2013 ED).

Staff comments and IASB discussion

- This issue affects the measurement of the insurance contract given it determines the CSM balance
- If an insurer does not use the OCI Solution it would expect to present the full effect from the time value of money in profit or loss.
- An accounting policy choice available for entities that want to use a current rate is not recommendable as it would result in differences in measurement
- This issue is not about cash flows but allocation of the originally discounted CSM to future periods as the service is provided.

IASB vote

- 10 IASB members were in favour of the staff recommendation and 4 against it

Presenting the effect of changes in discount rates

Changes in accounting policy

Issue

- Whether further guidance in addition to that included in IAS 8 is needed for the OCI Solution on insurance contracts given it will be introduced as an accounting policy choice
- Whether the retrospective application of changes in accounting policy should be removed for the OCI Solution

Staff recommendation

- An entity should apply the requirements in IAS 8 in full (including mandatory retrospective restatement) and without further guidance than already contained in IAS 8

Presenting the effect of changes in discount rates

Changes in accounting policy

Staff analysis

- The tentative decision to allow an accounting policy choice on whether to present the effect of changes in discount rate in profit or loss or OCI means that entities could change from period to period where to present those effects.
- IAS 8 requires that a change in accounting policy needs to provide more reliable and more relevant information.
- Comparability is ensured by retrospective application and disclosure of the amount of the adjustment for each period presented
- Restrictions for changes in accounting policy are well established and few issues have been reported in practice.
- The costs associated with retrospective application to present the effect of changes in discount rates in OCI are likely to encourage careful examination as to whether that change in accounting policy is made

Presenting the effect of changes in discount rates

Changes in accounting policy

Staff comments and IASB discussion

- One member disagreed with the staff recommendation on the retrospective restatement being a requirement because when the accounting for financial assets is changed as a result of a change in the business model that change is applied prospectively
- He would have preferred that the accounting for insurance contract liabilities that may be elected under IAS 8 at this time should only be changed prospectively.

IASB vote

- 10 IASB members were in favour, 2 members were absent and 2 members were against the staff recommendation

IFRS 9 – Financial Instruments

Accounting requirements

- Publication in July 2014 of the final IFRS 9 concludes the 5-year journey for a single and integrated standard for financial instruments, bringing together the three phases of the IASB's project to replace IAS 39: (a) classification and measurement; (b) impairment; and (c) hedge accounting.
- New classification and measurement requirements for financial assets:
  - based on two criteria: (a) business model for managing financial assets; and (b) the characteristics of the contractual cash flows of the financial assets
  - classification is made on the financial asset as a whole; bifurcation of embedded derivatives for financial assets is no longer required.
- Accounting for financial liabilities remain essentially unchanged from the IAS 39 model.
- IFRS 9 introduces new requirements for accounting of own credit changes which is now required to be recognised in OCI, rather than in profit or loss.

IFRS 9 – Financial Instruments

Accounting requirement (contd.)

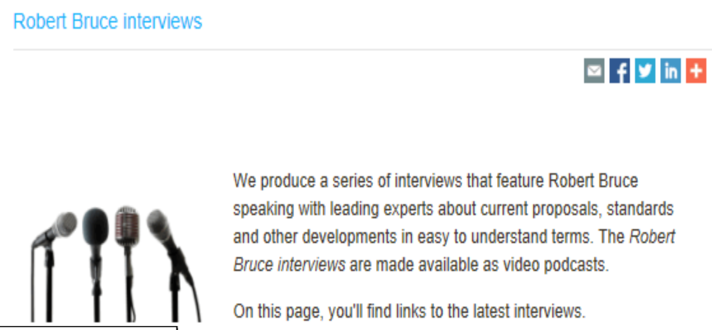
- Introduces a single impairment model, the “expected credit loss model”, for all financial instruments, which is forward-looking, rather than on an incurred basis.
- New hedge accounting requirements that result in a better reflection of the entity’s risk management activities.
- Effective date of IFRS 9 is 1 January 2018, subject to local endorsement requirements. Early application is permitted.
- Prior to 1 January 2018, the requirements on own credit risk changes can be applied at any time in isolation.

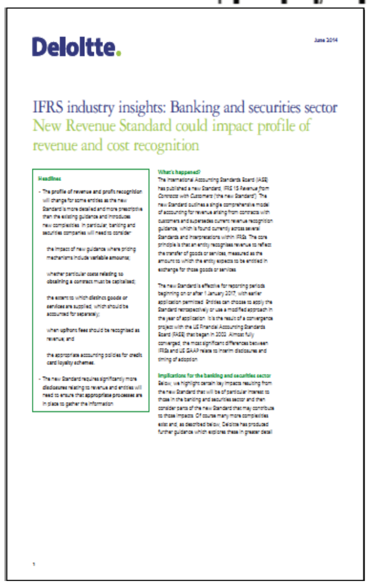
IFRS 9 – Financial Instruments

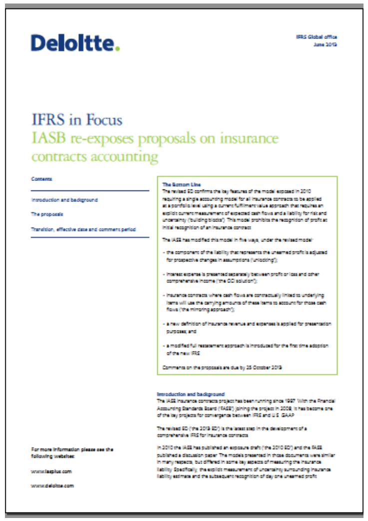
Deloitte Publications

Deloitte publications on IFRS 9 are available at www.iasplus.com

- Robert Bruce interviews
- IFRS in Focus
- IFRS Industry Insights







The next steps

Remaining issues, effective date and publication of the final standard

- The remaining issues to be discussed in future IASB meetings on contracts that do not have participating features only include minor follow up issues relating to OCI and the premium allocation approach
- The IASB plans to conclude its discussions on the adaptations to its tentative decisions that would be needed for contracts with participating features during its October meeting
- Transitional requirements for the first time adoption will be discussed as the last item, including the choice of the mandatory effective date
- The IASB expects that all redeliberations will be completed in 2014, with the publication of a final standard in the first half of 2015

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