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Progress towards finalising IFRS 4 Phase II slows down

Continuing education on participating contracts and decisions on PAA

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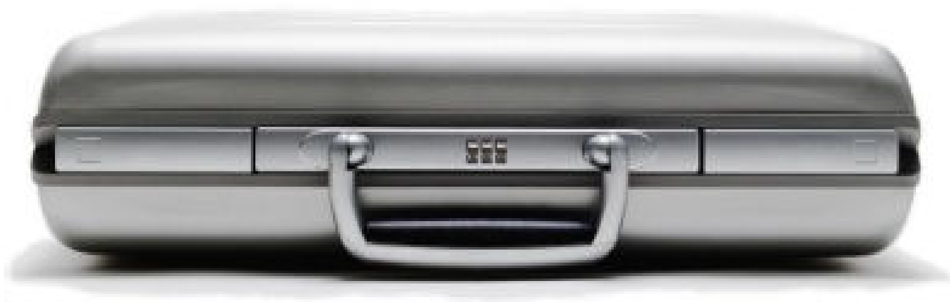

Agenda

- Highlights of discussions about participating contracts at IASB meeting
- IASB staff recommendations on PAA and Board tentative decisions
- Next steps and update on timetable

Highlights of discussions about participating contracts and the PAA

- **IASB meeting on 23 September 2014**

- **Educational session – participating contracts**
  - Book yield and effective yield approaches to presenting interest expense in profit or loss
  - Use of OCI for contracts with participating features
  - Should there be a book yield approach for determining interest expense in profit or loss?

- **Premium-allocation approach**
  - Revenue recognition pattern
  - Determination of interest expense

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

Objective

- To reduce accounting mismatches between the presentation of interest expense in profit or loss and interest income arising from the underlying items when there is an economic match between the underlying items and the insurance liability

Book yield method

- Identify the underlying items that determine the policyholder cash flows that vary with investment returns
- Determine the basis of the accounting for the return generated by such specified underlying items
- Construct a yield curve based on the book yield at each reporting date
- Adjust to eliminate any differences that arise on initial recognition of a contract

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

Staff proposal for book yield approach

- Only consider a book yield approach which minimises accounting mismatches with underlying items
- The Staff's proposed book yield approach ***would not*** be permitted when:
  - Equity investments are measured at FVOCI; and
  - Investment properties are measured at cost and the policyholder receives a share of the capital gains
- This approach ***would*** be permitted when the underlying items are, for example:
  - Bonds accounted for at cost, FVOCI or FVTPL provided that the effect of expected credit losses on the bonds accounted for at cost or FVOCI is reflected in the book yield;
  - Investment properties accounted for at cost when policyholders only benefit from a share of rental income; and
  - When the underlying items are accounted for at FVTPL

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

Staff proposal for book yield approach (cont.)

- This approach would ensure that at inception of the contract the yield curve for the presentation of the effect of discounting recognised in profit or loss is the same as the yield curve used for the measurement of the liability on the balance sheet

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

Effective yield approach (EYA)

- This approach is a form of the effective interest method used to calculate the amortised cost of financial instruments and to allocate the interest income or expense in profit or loss. This approach would mean that profit or loss would isolate the underwriting result, while changes in interest rate would be presented in OCI
- Two variations of the EYA were considered, being:
  - Level yield method
  - Projected crediting method

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

EYA Variation 1 – Level yield method

- Calculated on initial recognition of a contract as a single rate that exactly discounts estimates of future cash flows to the carrying amount of the liability on an amortised cost basis.
- The yield is reset when there are changes in estimated investment returns. The reset effective yield is the rate required to accrete amortised cost liabilities measured prior to a change in estimated cash flows to equal the revised expected cash flows when they take place on a level basis
- This is substantially the same approach used for financial instruments under IFRS 9

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

EYA Variation 2 – Projected crediting method

- Calculates discount rates on a basis that reflects the entity's projected crediting rates, i.e. the rates that the entity intends to use to determine the policyholder cash flows incorporating the share from the returns generated by the underlying items when they are accrued to the benefit of each policyholder (e.g. policyholder dividends, declared bonuses etc.)

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

Staff recommendation for how EYA should be considered

- The projected crediting method should be adopted because of its ability to reduce mismatches between investment income and interest expense when there are changes in estimates
- The Staff considered that interest based on crediting rates is closer to an incurred cost view of interest expense, as well as being more likely to mirror investment income when it is accounted for on an amortised cost basis

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

Staff comments and IASB discussion on book yield approach

- The salient points from the discussion were:
  - Whether instead of using OCI it would be better to unlock the shareholders share of the CSM to reflect the effect of changes in discount rates
  - Questioned how many insurers would use the book yield approach when designation of items at FVTPL is available
  - Insurance liabilities often extend beyond the duration of the backing assets, which is why the insurance industry feels that the use of OCI is preferable to avoid profit being distorted.
  - Some IASB members expressed views in support for the book yield approach as it largely eliminates accounting mismatches
- The Staff confirmed that they are looking into book yield approaches both with and without the use of OCI

Educational session – Participating contracts

Book yield and effective yield approaches to presenting interest expense in profit or loss

Staff comments and IASB discussion on effective yield approach

- The salient points from the discussion were:
  - The Staff confirmed that the underlying items were not restricted to asset returns but also included all variable returns, e.g. the benefits of mortality gains and cost savings
  - Some financial assets would be accounted for at FVTPL because of the characteristics of the instruments, therefore use of the effective yield method would create accounting mismatches
  - Refinements to the effective yield to reset the effective yield on recognition of realised gains/losses when underlying items are accounted for under a mixed model were not recommended by the Staff due to complexity. There were mixed views among the IASB members on whether such refinements made the approach too complicated or not

Educational session – Participating contracts

Use of OCI for contracts with participating features

Issues

- Whether the effects of changes in discounts rates should, or may be, presented in OCI
- The scope of the book yield and effective yield approaches when considered in the context of an IFRS that offers an OCI solution
- Whether adaptations are needed to the general model for participating contracts that the IASB believes:
  - ***should not*** be accounted for using either the book yield or the effective yield approaches, and
  - ***could*** be accounted for using the effective yield approach but ***should not*** be accounted for using the book yield approach.

Educational session – Participating contracts

Should there be a book yield approach for determining interest expense in profit or loss?

Issues

- Strictly connected with the previous set of issues
- Whether the book yield approach should be used to determine the interest expense for contracts where the cash flows that vary with investment returns on underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract, and:
  - the returns to be passed to the policyholder arise from the underlying items that the entity holds;
  - the policyholder will receive a substantial share of the total return on the specified underlying items; and
  - applying the book yield approach would reduce or eliminate the accounting mismatches in profit or loss between the insurance contract and the underlying items.

Educational session – Participating contracts

Should there be a book yield approach for determining interest expense in profit or loss?

Staff recommendations

- The Staff recommended the following interaction between the OCI solution and the approach to determine the interest expense in profit or loss

Interest expense in profit or loss is based on:	Non-participating contracts and contracts without substantial participation	Participating contracts – no underlying items held	Participating contracts – underlying items held
Locked-in discount rate curve	**Required when OCI solution is elected**	Not permitted	Not permitted
Book-yield rate curve	Not permitted	Not permitted	**Permitted only outside OCI solution**
Effective-yield rate curve	Not permitted	**Required in all cases**	**Required when OCI solution elected**

Educational session – Participating contracts

Should there be a book yield approach for determining interest expense in profit or loss?

Staff comments and IASB discussion on when it is appropriate to use the book yield approach

- The salient points from the discussion were:
  - One IASB member reiterated his view that OCI should not be used for insurance contracts with or without participating features
  - There would be an OCI accounting policy choice for insurance contracts but there is less freedom for financial assets given the criteria in IFRS 9. Some criteria may be necessary to determine the most appropriate accounting policy for insurance contracts in order to minimise accounting mismatches
  - If it was decided not to allow the use of OCI for contracts with participating features it would be necessary to do likewise for contracts without participating features. An alternative tool would be to unlock the CSM
  - The Staff confirmed that if unlocking the CSM for changes in the discount rates was required the use of OCI would become redundant.

Premium-allocation approach

Revenue recognition pattern

Issue

- Whether guidance should be provided on the pattern of recognition of the insurance contract revenue in the PAA, based on the provision of insurance coverage

Staff recommendations

- Under the PAA an entity should allocate insurance contract revenue in profit or loss in a systematic way that best reflects the transfer of services
- Transfer of services should be clarified as occurring:
  - on the basis of the passage of time and the expected number of contracts in force; but
  - if the expected pattern of release from risk differs significantly from the passage of time, then the basis of the expected timing of incurred claims and benefits should be used as the measure of service occurrence

Premium-allocation approach

Revenue recognition pattern

Staff comments and IASB discussion

- The salient points from the discussion were:
  - The Staff stated that guidance was needed in order to prevent diversity of approach and a lack of comparability
  - It was noted that it was the value as well as the number of contracts that was relevant, and the Staff confirmed that they would clarify this
  - There were questions about what was meant by the transfer of services, and whether this was limited to claims, or also included other costs that are incurred over the duration of the contract and the stand-ready obligation to meet claims

IASB vote

- A unanimous vote from the 14 IASB members was cast in favour of the staff recommendation

Premium-allocation approach

Determination of interest expense in the premium-allocation approach

Issue

- How to determine interest expense for the liability for incurred claims in the PAA, and in particular whether this discount rate should be the locked-in rate at the inception date

Staff recommendation

- When an entity presents the effects of changes on discount rates in OCI, the discount rate that is used to determine the interest expense for the liability for incurred claims in the PAA should be the rate locked-in at the date the claim was incurred.

Premium-allocation approach

Determination of interest expense in the premium-allocation approach

Staff comments and IASB discussion

- The salient points from the paper and the discussion were:
  - The paper noted that if the rate at inception of the contract is used, a catch-up adjustment must be recognised in OCI to reflect the effect of changes in discount rates between the date of the contract inception and the date when the claim is incurred
  - This adjustment may be difficult to explain because no gains or losses would otherwise be separately recognised in the SOCI relating to any changes in assumptions between the date of inception of the contract and the date when the claim is incurred
  - In the Staff's view this adjustment would mean that using a discount rate locked-in on a date other than the date the claim is incurred would add complexity without bringing significant benefits

IASB vote

- A unanimous vote from the 14 IASB members was cast in favour of the staff recommendation

The next steps

Remaining issues, effective date and publication of the final standard

- The IASB plans to conclude its discussions on the adaptations to its tentative decisions that would be needed for contracts with participating features starting from 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
- Based on the updated work plan published on 26 September, the IASB expects that all redeliberations will be completed in 2014, with the publication of a final standard in the first half of 2015

- Noteworthy is the FASB decision at their meeting on 27 August 2014 to introduce a current measurement basis to account for long-duration insurance contracts where in the past US GAAP had used a “locked-in” basis.
- This is part of the FASB project to approve targeted improvements to the accounting for long-duration contracts.

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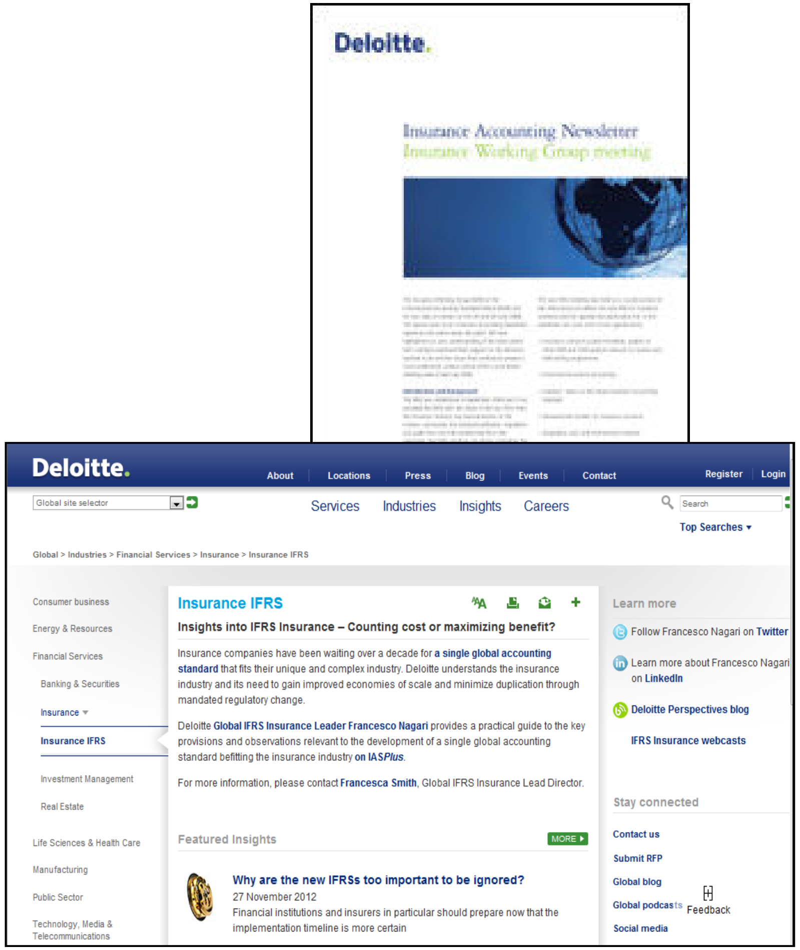

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