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Notes from the IASB meeting held on 22-24 July 2014

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Insurance contracts

The IASB held an educational session on 22 July 2014 to discuss Agenda paper 2A *OCI mechanics for contracts with participating features*, which continues the IASB's discussion of the adaptations that it might consider to account for contracts with participating features. The Staff requested the IASB to provide directions for future work on specific issues, but no decisions were taken at the meeting.

This session was immediately followed by a meeting to discuss Agenda paper 2B *Rate used to accrete interest and calculate the present value of cash flows that unlock the contractual service margin*, which considers whether the rate used to accrete interest on the contractual service margin (CSM) and to calculate the present value of cash flows that offsets (unlock) the CSM should be the current rate or the locked-in rate.

Agenda paper 2C *Changes in accounting policy* considers existing requirements for changes in accounting policies and considers if further requirements are needed for insurance contracts given the IASB decision to allow an accounting policy choice at portfolio level to elect the presentation of the time value of money and the changes in discount rates between the profit or loss and the other comprehensive income. This paper also considers an issue relating to the retrospective application of changes in accounting policy that was identified in the March 2014 IASB meeting.

OCI mechanics for contracts with participating features (Agenda paper 2A)

This paper discusses an approach for determining interest expense and, therefore, the amounts to be presented in profit or loss and Other Comprehensive Income (OCI). Understanding the mechanics for determining interest expense is essential in assessing whether presenting the effects of changes in discount rate in OCI would provide useful financial information.

The Staff plan to ask the IASB at a future meeting whether the effects of changes in interest rate should, or may, be presented in OCI and if so, what approach should be used to determine the interest expense in profit or loss. Assuming that the IASB decides that these effects should be presented in OCI in some circumstances, the Staff proposals for the discount rate to be used for presentation in profit or loss were as follows:

(1) There should be a single discount rate for *all* the cash flows in the contract and this discount rate would not be locked-in at the inception of the contract.

Instead, it would be reset whenever there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders. This presentation discount rate is used if and only if 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 2013 ED already contemplated a reset rate for asset dependent cash flows (paragraph 60(h)). However it would have required a different locked-in discount rate for cash flows that are not asset dependent (e.g. contract expenses); and

(2) the discount rate used for the presentation of interest expense in profit or loss should be determined using an approach similar to the effective interest rate (EIR) method for floating rate debt instruments (e.g. where the EIR is regularly reset). This is instead of the 2013 ED proposal to lock-in the yield curve at the initial recognition date of the insurance contract.

Although it is conceptually more appropriate for interest presented in profit or loss to be determined using discount rates that reflect the different characteristics of the cash flows, the Staff agree that it would be complex and costly. Particularly as this would only be required for presentation purposes. The inherent subjectivity of the judgment required to determine which cash flows should be discounted using locked-in or reset rates could also undermine the comparability of the information provided, because it may result in entities reporting different amounts as interest expense in profit or loss.

Accordingly, the Staff proposed that there should not be any requirements that result in the need to split the cash flows for presentation purposes as proposed in the 2013 ED and that resetting the discount rates for all cash flows would be most appropriate when it is true that the majority of the cash flows varies with underlying items and it would have resulted in a reset rate presentation basis being adopted for those even under the 2013 ED.

The second recommendation would change the requirement to lock-in and reset the discount rate curve and it would replace it instead with the EIR method. The mechanics of the EIR approach would average the discount rate differences between periods rather than using a discount rate curve for the different cash flows durations. Although not as simple as using a locked-in/reset yield curve, the EIR method could reduce the accounting mismatch in profit or loss if the underlying items are debt instruments at amortised cost or at fair value through OCI.

IASB members were generally supportive of developing an approach based on the EIR method. One member stated that the two approaches need to be better understood relative to each other before the IASB decides on which approach to adopt. Another IASB member questioned whether there was a need for a bright line for the underlying items to be a “substantial proportion” of the total benefits to the policyholder. The Staff commented that the EIR method could be extended to all insurance contracts, but are asking for tentative direction only at this meeting as it may be too soon to decide on this until a decision is reached on participating contracts. Another IASB member felt that the example in paper 2A may be lulling the

IASB into a false sense of security as it is based on a fixed rate bond therefore it is important to consider other more realistic scenarios.

Rate used to accrete interest and calculate the present value of the cash flows that unlock the contractual service margin (Agenda paper 2B)

The CSM is determined net of the effect of time value of money at initial recognition. The 2013 ED proposed to accrete interest on the CSM using the same discount rate used at initial recognition and not to change if interest rates fluctuate. The same locked-in discount rate would be applied to calculate the adjustments to the CSM that come from the unlocking requirement in subsequent measurement periods. This paper considers whether the rate used for the measurement of these unlocking adjustments and of the accretion should instead be based on the current discount rate used for the measurement of the cash flows at the reporting date. This paper considers only contracts without participating features with the applicability to contracts with participating features to be concluded in due course.

Accretion of interest

Some respondents to the 2013 ED suggested that a current rate should be used for the interest accretion to be consistent with all the other components of the insurance contract liability on the statement of financial position. Some constituents (especially some field test participants) thought that tracking the locked-in rates would be too burdensome particularly in the event, as it happened, that the OCI solution is not mandatory and only current discount rates are used for the measurement and presentation of the impact of time value of money for any other component of the insurance liability. Other respondents to the 2013 ED agreed with the proposals to use the locked-in interest rate because they believed it to be conceptually correct and because it would avoid interest rate volatility in reported profit by remaining fully consistent with the OCI solution to present the effect of changes in discount rates.

The Staff reiterated that a locked-in rate is conceptually correct and it would result in more useful information because it retains a clean separation of underwriting and investment results. The Staff noted that although the use of the locked-in rate is operationally more demanding when the insurer chooses the accounting policy to recognise the whole effect of changes in discount rates in profit or loss, they concluded that this accounting policy choice should not be extended to the CSM interest rate accretion because this would create differences in the measurement of the CSM of an insurance contract depending on the policy on the presentation of the unwinding of the discounting of the cash flows.

Unlocking the CSM

In the 2013 ED, the IASB proposed that the CSM would be adjusted for changes in the present value of cash flows related to changes in expected timing and expected amounts to be paid in future coverage periods (the unlocking of the CSM). However, the IASB proposed that the effect of the changes in the discount rate should not be offset in the CSM, so as to avoid accounting mismatches that would otherwise arise between those changes and the equivalent changes in the return on the assets held by the entity. This would also avoid recognising investment gains or losses as part of the underwriting margin. Some respondents to the 2013 ED disagreed that the locked-in rate should be used to determine the present value of cash flows that is offset against the CSM as (1) they believed that the costs of tracking the locked-in discount rate when that information is not needed to determine the amounts to be recognised in OCI would not be justified, and (2) using the current rate would better reflect the change in economic cost.

In the Staff's view, the separation between underwriting and investment margins is a core benefit of the new IASB's model. Furthermore, regardless of whether the insurer presents the effect of discount rate changes in profit or loss or OCI, using locked-in rates for determining the present value of cash flows to unlock the CSM better separates the underwriting and investment results. In contrast, if current rates were used, some changes in discount rate (and thus changes that should be treated as investment results) would be reported in the underwriting result through the release of the CSM. In addition, when an entity unlocks the CSM for the present value of cash flows calculated using the current rate, additional complexity arises because the cumulative OCI under an OCI accounting policy would be more difficult to explain and calculate.

The Staff recommended that, for contracts without participating features, an entity should use the locked-in rate at the inception of the contract for accreting interest on the CSM and for calculating the change in present value of expected cash flows that offsets that margin, which is the proposal in the 2013 ED.

Two IASB members questioned whether there should be an accounting policy choice for entities that want to use the current rate. One IASB member stated that if an insurer does not use OCI or this is of limited use, it would want to see all the effects of interest rate fluctuations in the profit or loss. The Staff felt that this was much more than a presentation issue as it affects the measurement of the insurance contract CSM balance carried forward. The Staff felt that their recommendation was worthwhile from a cost/benefit view. They stated that the costs were higher for those that did not choose the OCI option, but giving an accounting policy choice is not sensible as it would impact the measurement of the insurance contract liability via the CSM balance being different, all other things being equal, simply because of the different choice of discount rate on the adjustments that unlock the CSM. Comparability would be significantly decreased, and there would be a different total comprehensive income over the life of the contract.

One of the IASB members commented that this issue is not about cash flows but allocation of the CSM to future periods as the service is provided. Another IASB member asked why, in these circumstances, it was necessary to accrete interest on the CSM. The Staff commented that in terms of cash flow, interest accretion does not use a locked-in rate; therefore the final amount will be different. An estimate is made on day 1, but on day 2 the estimate may change. The discount rate is never unlocked against the CSM in the current proposed new IFRS model.

Another of the IASB members stated that he favoured a current rate rather than a locked-in rate because, for entities not using the OCI solution, requiring the accounting using the locked-in rate is an operational burden, as a current rate will be used for the rest of the model. This requirement will force them to keep locked-in rates information. However, for companies who choose the OCI option the locked-in rate makes more sense.

Another IASB member agreed that an accounting policy election could be linked with the choice of the OCI option. Another one disagreed with that position because it may create different carrying amounts for the same contract and he was, on balance, in favour of using the locked-in rate.

When called to vote by the Chairman, 9 IASB members were in favour of the Staff recommendation against 5 dissenting members; 2 members were absent from the meeting.

Changes in accounting policy (Agenda paper 2C)

During previous meetings the IASB tentatively decided that an entity should choose to present the effect of changes in discount rates in profit or loss or in OCI as an accounting policy choice and should apply that accounting policy to all contracts within a portfolio. It also clarified that an entity should select and apply its accounting policies consistently for similar contracts, considering the portfolio in which the contract is included, the assets that the entity holds and how those assets are accounted for.

The IASB considered whether existing requirements for changes in accounting policies are sufficient or if further requirements are needed when applied to the accounting for the time value of money in an insurance contract. The IASB also considered whether or not it should introduce an exemption to retrospective application of changes in accounting policy that introduce the use of the OCI solution.

The Staff recommended that the requirements in IAS 8 *Accounting policies, Changes in Accounting Estimates and Errors* to changes in accounting policy relating to the presentation of the effect of changes in discount rate are sufficient and no additional guidance or exemptions from the retrospective restatement are required. The requirements of IAS 8 mean that an entity would need to justify a change in accounting policy as providing reliable and more relevant information, and the justification for changes in accounting policy would be disclosed.

In the Staff's view the IAS 8 requirement are sufficient because they would already act as a barrier to frequent changes in accounting policy given that the production of more reliable and more relevant information is an effective test and the IAS 8 disclosure requirement would allow users of financial statements to easily scrutinise any changes in accounting policy, the reasons for, and the impact of, the changes. This framework is well-established and few issues have been reported in practice. Finally, the Staff noted that the costs associated with retrospective application of an accounting policy to present the effect of changes in discount rates in OCI are necessary to encourage careful examination of whether a change in accounting policy should be made.

The fact that retrospective changes in accounting policy for insurance contract liabilities would be reported when the accounting for financial assets changes as a result of a prospective reclassification in accordance with IFRS 9 *Financial Instruments* (e.g. assets are reclassified following changes of the insurer's business model) generated concern that accounting mismatches would be reported in the comparative period as a result of the liability being restated whereas the assets not being restated. However, changes in the business model for managing financial assets are expected to be very infrequent.

A more likely reason for an entity changing its accounting policy for insurance contract liabilities would be changes in the assets that it uses to back the insurance contracts as a result of disposals and purchases with different accounting elections made for the new assets. In this instance the Staff believe that the financial statements for the current and comparative period would be likely to include accounting mismatches as a result of the gradual change in assets mix and the accounting thereof. The waiver from the IAS 8 restatement would not resolve this issue.

One of the IASB members disagreed with the Staff recommendation as he felt that when the accounting for financial assets is changed prospectively, the accounting for insurance contract liabilities should not be changed retrospectively.

When called to vote by the Chairman, 10 IASB members were in favour of the Staff recommendations and 2 members were against the Staff recommendation; 2 members were absent from the meeting.