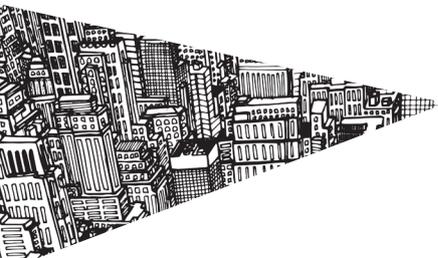


Insurance Accounting Alert

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IASB makes progress by reaching decisions on the PAA; and continues educational discussions on participating contracts

What you need to know

- ▶ The Board held another educational session on participating contracts to discuss the interest expense in profit or loss; no decisions were made.
- ▶ The Board tentatively agreed on the guidance for recognising insurance contract revenue and determining the interest expense in profit or loss when applying the premium allocation approach.

Overview

During its September 2014 meeting, the International Accounting Standards Board (IASB, or Board) continued re-deliberations on its 2013 Exposure Draft Insurance Contracts (ED). The Board held an educational session on contracts that contain participating features (participating contracts), in which it provided the staff with further provisional direction on the model for such contracts.

The Board also held a decision-making discussion on two topics for the premium allocation approach (PAA):

- ▶ Pattern of revenue recognition
- ▶ Determination of interest expense in profit or loss

Participating contracts (educational session)

The staff explained that the starting point for participating contracts will be the general building block model applied to non-participating contracts, but noted that adaptations would be necessary to reflect the unique aspects of participating contracts. At previous meetings, the Board had discussed several features of such a model and in September, it explored potential methods of recognising the interest expense in profit or loss. However, the Board was not asked to make any decisions.

The staff noted that IFRS 9 *Financial instruments*, and other standards that are relevant to the accounting for items underlying the participating contracts (e.g., financial assets), could result in an insurer carrying these items at different measurement bases. The staff felt any alternatives for determining the interest expense in profit or loss on participating contracts should be aligned with how returns on instruments backing the participating contracts are reflected in profit or loss as much as possible, including the use of other comprehensive income (OCI) for presenting the effects of changes in discount rates. However, accounting mismatches may not be solved entirely because of differences in the way returns and discount rates are calculated on the assets and liabilities. The staff identified two alternatives the Board might wish to consider:

- ▶ Book yield
- ▶ Effective yield



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Book yield

Under the book yield method, the rate for calculating the interest expense would be based directly on the accounting returns in profit or loss from the underlying items. An entity first would identify the underlying items, including, but not limited to, financial assets. The entity would derive the accounting returns (i.e., book yield) in profit or loss under IFRS for these underlying items, e.g., the returns for instruments that are at fair value through profit or loss (FVPL) and effective interest rates of debt instruments at fair value through other comprehensive income (FVOCI). The accounting returns would be used to construct a yield curve for the entire duration of the estimated cash flows of participating contracts, taking into account reinvestment assumptions based on current market yields as the duration of the liability cash flows would often extend beyond the duration of the underlying items.

The book yield approach as recommended by the staff would:

- ▶ Be limited to situations where its use would minimise mismatches with the accounting for the underlying items
- ▶ Include a mechanism to eliminate any 'day one' OCI effects caused by differences between the book yield and the current market yield at inception of an insurance contract.

Effective yield

An effective yield approach can be seen as applying a form of an effective interest rate method to allocate the interest expense to profit or loss over time. The effective yield is recalculated ('reset') when the insurer expects that there will be changes in expected payments to policyholders as a result of changes in the expected returns on underlying items. One way to implement the effective yield method is to determine the

interest expense on the basis that the yield on the underlying items is level over time. The staff referred to this approach as the level yield method.¹ However, the staff noted that the level yield method would result in a mismatch between patterns of: (a) the interest expense for the insurance liabilities based on the level yield; and (b) the returns on the underlying items. Therefore, the effective yield method proposed by the staff would apply a constant spread over the rates that an entity would expect to credit to its policyholders (projected crediting rates) to avoid the mismatch between these patterns. Under the effective yield method recommended by the staff, an entity would have to choose as its accounting policy whether to recognise changes in discount rates in profit or loss or OCI.

Scope is another critical area that the Board needs to consider. Following the direction provided during the June Board meeting², the staff believes that the Board may consider using the book yield if all of the following criteria are met:

- a) Where the returns to be passed to the policyholder arise from the underlying items that the entity holds
- b) Where the policyholder will receive a substantial share of the total return on the specified underlying items
- c) Applying the book yield approach would reduce or eliminate the accounting mismatches in profit or loss between the insurance contract and the underlying items

Having weighed up several factors, including the effect on accounting mismatches and complexity, the staff indicated that they believe the effective yield method applies to all contracts where the participating cash flows are a substantial portion of the total benefits to the policyholder. If the

¹ The US Financial Accounting Standards Board proposed an effective yield method for determining and resetting the crediting rates for contracts with discretionary participation features in its *Proposed Accounting Standards Update Insurance Contracts* (June 2013).

² See *Insurance Accounting Alert*, July 2014, *IASB discusses discount rates, reinsurance contracts and level of aggregation*.

participating cash flows would not form a substantial portion of the total benefits, an entity should apply the locked-in rate for determining the interest expense in profit or loss.

The staff asked the Board for feedback on the proposed methods, which led to a lively debate with Board members raising numerous arguments and concerns. Many Board members noted the importance of avoiding accounting mismatches and concluded that, of the two methods proposed by the staff, the book yield method dealt best with accounting mismatches, also acknowledging that the book yield method is the most complex. Some Board members therefore suggested the staff might wish to explore whether the effective yield method could be modified to deal more effectively with accounting mismatches. Many Board members also acknowledged that the concept behind the book yield method (i.e., the direct link between the interest expense on the liabilities and the accounting returns of the assets) results in the need to restrict the scope of the book yield, but felt that the scope suggested by the staff would be too narrow. A number of Board members commented that the issue of how to calculate the interest expense in profit or loss interacts with the issue of whether to unlock the CSM for changes in the shareholders' share in the underlying items.

The staff acknowledged interaction exists between various aspects of the model for participating contracts and noted that it will bring the complete package to the Board at a final decision-making meeting. The staff confirmed it will continue to explore both a book yield method and an effective yield method when further developing the model for participating contracts. The staff noted that it would evaluate the direction given by the board that resolving accounting mismatches might outweigh complexity. The staff also plans to consider the feedback to explore aspects such as:

- ▶ Modifying the effective yield method to better deal with accounting mismatches
- ▶ Widening the scope of circumstances under which the book yield method could be used
- ▶ Whether it would be possible to have an approach to determine the interest expense for participating contracts without the use of OCI

The staff emphasised that any direction given by the Board should be regarded as preliminary and would depend on whether the Board decides, in future meetings, to pursue certain alternatives.

How we see it

The discussions at the September meeting indicate the Board's intention to reach a decision on the model for participating contracts in its entirety. This approach allows the Board to make informed decisions on aspects of the entire package and consider all the interactions within the model. However, one of the outcomes of this approach is that the re-deliberations on participating contracts will take longer than the IASB had originally anticipated, which may extend the timeline of the project.

Premium allocation approach (decision-making)

The staff reminded the Board that the goal of the PAA is to provide a simplification to the general building block approach, which is expected to cover, but is not necessarily limited to, many short-duration contracts. During this meeting, the staff asked the Board to make a decision on the following issues regarding the PAA:

- ▶ Pattern of revenue recognition
- ▶ Determination of interest expense in profit or loss

Revenue recognition pattern

The staff reminded the Board that it decided that the transfer of services for non-participating contracts accounted for under the building block contract should be reflected on the basis of passage of time. The staff believes specific guidance is needed for contracts accounted for under the PAA as this model does not contain an explicit risk adjustment to reflect the release from risk in profit or loss separately during the coverage period. The staff therefore recommends an entity should recognise insurance contracts revenue under the PAA:

- a) On the basis of the passage of time
- b) But If the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits



The staff clarified that its recommendation entails the use of a single driver to achieve simplicity; an entity should apply either pattern (a) or (b) above to a contract, but not a combination of the two. The staff acknowledged that, when applying the expected timing of incurred claims and benefits, in an extreme case where no claims were expected during the first half of the year, all revenue would be recognised during the second half of the year. The staff believes a single driver would result in a less precise answer, but considers this to be the consequence of trying to avoid complexity in the application of the PAA. All Board members supported the staff recommendation.

Interest expense in profit or loss

The staff explained that, for non-participating contracts, entities can choose to recognise the effects of changes in discount rates in either profit or loss or OCI as their accounting policy. When applying the PAA, an entity would have to choose whether to recognise these changes in OCI or profit or loss for their incurred claims liabilities. For instances where OCI is chosen, the staff asked the Board to consider whether the interest expense in profit or loss should be determined based on the discount rate determined at inception of the contract or on the date the claims are incurred. The staff recommended the Board to select the latter considering that many comment letters contained significant concerns about increasing complexity if the discount rate at inception of the contract has to be used. The staff believes that the additional benefits of using the discount rate at inception would not outweigh the increase in operational complexity.

One Board member queried whether it would be logical to force the use of an operational simplification upon entities. The staff responded that none of the respondents had asked to keep the use of the discount rate at inception as a possible alternative. All Board members agreed with the staff recommendation.

How we see it

The Board's decision, following the staff's recommendation, to select the simple answer reflects its desire to avoid complexity in the application of the PAA as much as possible. If an entity believes that more precision is needed for some of its contracts that are eligible for the PAA, it could consider applying the building block model to these contracts instead.

What's next?

The Board's next meeting on the insurance contracts project is in October 2014; the topics have not yet been announced. The IASB expects to complete redeliberations on its insurance contracts proposals in 2014, with the publication of the final standard in 2015.

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