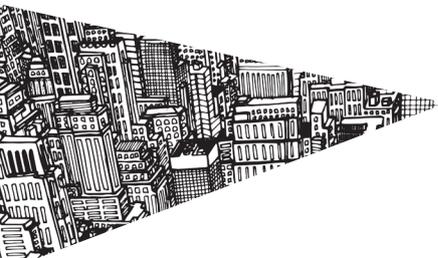


Insurance Accounting Alert

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IASB discusses OCI for participating contracts, CSM and policy change requirements

What you need to know

- ▶ The IASB instructed its staff to explore the use of an approach similar to the effective interest rate method for determining the interest expense for participating contracts in addition to the book yield method.
- ▶ The interest rate at inception should be locked in and used to accrete interest on the CSM, as well as for recalculating the present value of cash flows to unlock the CSM.
- ▶ IAS 8 guidance should be followed for a change in the accounting policy regarding where to present the effects of changes in discount rates.

Overview

During its July 2014 meeting, International Accounting Standards Board (the IASB or the Board) continued its re-deliberations on the 2013 insurance contracts exposure draft (ED). It held decision-making discussions on the following topics:

- ▶ The discount rate to use for the contractual service margin (CSM) interest accretion and calculation of the present value of cash flows to unlock the CSM
- ▶ Whether requirements beyond IAS 8 *Accounting policies, changes in accounting estimates and errors* would be needed for a change in accounting for the presentation of the changes in interest rates

In terms of determining the interest expense for participating contracts, an educational session was held to decide whether the effective interest rate method (referred to as the EIR approach in this publication) should be further explored.

Determining interest expense for participating contracts

Although the IASB has yet to decide where to present the effect of changes in interest rates for participating contracts, the staff are proceeding on the assumption that certain interest rate changes will be presented in other comprehensive income (OCI). Therefore, they have been exploring alternative ways to determine interest expense when the OCI option is used.

The Board indicated that having guidance that is only applicable to certain participating contracts would require the contracts that fall under that guidance to be clearly defined. The IASB staff felt that, in practice for most contracts, it will be quite clear whether a substantial proportion of the cash flows would vary with the underlying item. As such, they were not concerned about a potential lack of consistent application. Some Board members noted that the staff's suggested way to identify the type of participating contract, using the concept of the predominant nature of cash flows, needs clarification.

Overall, the Board supported the staff in exploring the use of the EIR approach for determining interest expense for at least some participating contracts. However, a few Board members expressed concern about the numerical example the staff had used in the agenda paper. Those members thought that, in particular, the six-year fixed interest bond investment was over-simplified. They felt that a more complex investment portfolio with shorter duration assets might highlight challenges that the simplified example would not show. As such, the staff were asked to explore other more complex situations, such as variable rate assets or one-year assets backing the insurance liability in their further analysis of the EIR approach.



Building a better
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Several Board members inquired whether the EIR approach should be used for both participating and non-participating contracts. The staff explained that they had not yet considered whether the EIR approach would equally be applicable to non-participating contracts and recommended that the Board consider at a later date whether the method they decide on for participating contracts should also be used for non-participating contracts. The Board agreed and instructed the staff to evaluate participating contracts first.

Non-participating contracts: interest rates and the CSM - current rate or locked-in rate?

In the context of non-participating contracts, the IASB discussed whether a current rate or a locked-in rate should be used for:

- ▶ The accretion of interest on the CSM
- ▶ The calculation of the present value of cash flows to unlock the CSM

Depending on what interest rate is used, the measurement of the CSM and, consequently, the total insurance liability is different.

Accretion of interest

The staff noted in their agenda paper that a locked-in rate should be used for interest accretion to the CSM, because:

- ▶ It is conceptually correct, as it reflects the time value of prices and services that were agreed at inception
- ▶ The CSM is not unlocked for changes in discount rate, and using a locked-in rate is consistent with that approach

- ▶ It leads to accounting similar to a prepayment for non-insurance services (IFRS 15 *Revenue from Contracts with Customers*) and the premium allocation approach
- ▶ It provides more useful information by separating underwriting and investment results

Unlocking

Regarding unlocking, the staff argued that using locked-in rates better separates underwriting and investment results, which it considers to be a core benefit of the IASB's model. Also, using a current rate to unlock the CSM would make it rather difficult to calculate the cumulative OCI amount, if using the OCI model is the entity's policy.

Recommendation

For non-participating contracts, the staff recommended the use of locked-in rates for both the accretion of interest to, and the unlocking of, the CSM.

Discussion

Several Board members felt the mechanics of the suggested development of the CSM were not clear. Those Board members pointed out that only at inception of the contract does the CSM represent the difference between the present values of two cash flows, hence the need to require the accretion of interest. After inception, the CSM essentially represents a

reallocation of that initial amount to reflect the remaining unearned profit and the unlocking of that initial amount when the underwriting outcome is re-estimated.

Other Board members either advocated the use of a current rate or queried the mandatory use of a locked-in rate, mostly for operational reasons. In the staff's view, however, the complexities of both approaches are finely balanced.

The staff had also considered the suggestion of some constituents that the CSM accretion or unlocking should follow the chosen accounting policy for discount rate changes (P&L or OCI), but ultimately rejected that suggestion, as this would permit measurement differences to occur based on a choice of presentation.

The staff cautioned the Board that not using a locked-in rate could lead to different measurement of the liabilities and shifts between OCI and profit or loss (OCI alternative for interest changes) or between lines in profit or loss (profit or loss alternative for interest rate changes). Additionally, differences in ultimate total comprehensive income could occur. After this technical discussion, the majority of Board members voted in favour of the use of a locked-in rate for both interest accretion and unlocking, partly due to the absence of a better alternative.



How we see it

Locking in the accretion rate could be seen to be inconsistent with the overall concept that the CSM will be a current estimate of the expected remaining profit from the cash flows of the insurance contract. Similar to difficulties that certain Board members experienced when evaluating the mechanics of the locked-in accretion method, both preparers and users of financial statements will need to understand the mechanics thoroughly to be able to explain what the CSM represents at the balance sheet date.

Change of accounting policy for the presentation of the effect of interest changes in profit or loss or OCI: are the requirements in IAS 8 sufficient?

In March 2014, Board members had specifically questioned whether the retrospective application of changes relating to insurance liabilities was appropriate when, in the same accounting period, some changes relating to financial instruments (reclassifications as a consequence of a change in business model) would be accounted for prospectively. Some Board members felt that comparative information would neither be meaningful nor useful; the liabilities would be restated, but not the financial assets.

During this meeting, the staff recommended that, despite the difference in how changes in classification of financial instruments are reported versus how changes in insurance liability accounting policies would be reported, there should not be specific guidance for insurance contract accounting policy changes. The staff saw no reason to expand on the requirements of IAS 8 to provide specific guidance as part of their insurance contracts project because it would be difficult to demonstrate that frequent changes in accounting policy result in relevant and reliable information. Other deterrents mentioned were that such changes are costly and would likely be scrutinised by users if they occurred frequently. The staff expected reclassifications of assets only at the start or end of a significant activity, such as the acquisition, disposal or termination of a business line.

More frequently, an insurer would want to change its accounting because of a gradual change in the mix of assets backing the insurance liabilities (hence, the policy choice), but in that case, a restatement of comparatives would not always result in an increase in accounting mismatches, in the staff's view.

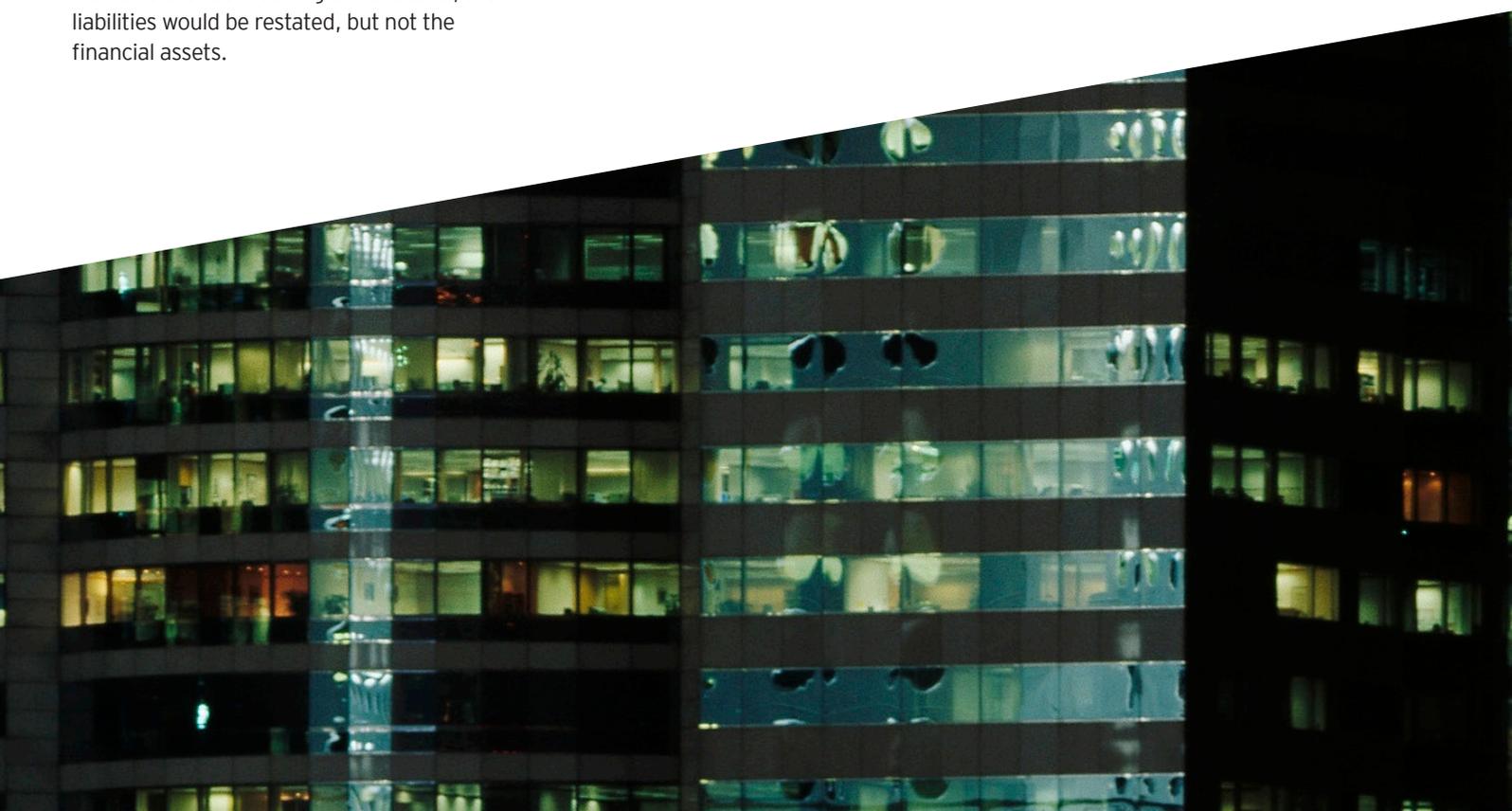
After a brief discussion, the majority of Board members agreed that the insurance standard should not contain requirements in addition to those set out in IAS 8 for accounting changes in respect of the presentation of changes in discount rate.

How we see it

The Board continues to work to align the accounting for insurance contracts as closely as possible to the overall concepts in IFRS to avoid insurance contract accounting being perceived as a different accounting model.

What's next?

The Board's next meeting on the insurance contracts project is in September, the topics are yet to be determined. The IASB expects to complete re-deliberations on the insurance contracts proposals in 2014, with the publication of a final standard in 2015.



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