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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **18 July 2006, London**

Project: **Insurance contracts (phase II) (Agenda Papers 8, 8A and 8B)**

AGENDA PAPER 8

Purpose of this paper

1. This paper provides a timetable up to the publication of the discussion paper (preliminary views), and draft chapter headings for the discussion paper.

2. Other papers for this meeting deal with:

   (a) Changes in insurance liabilities (agenda paper 8A)

   (b) Unit-linked payments (agenda paper 8B).

Timetable

Topic and summary of content	**Date**
First pre-ballot draft: o Chapter 1 Introductory material o Chapter 2 Recognition and derecognition o Chapter 3 Measurement - core issues o Chapter 4 Renewals, customer relationships o Appendices A-D and H [see enclosed draft chapter headings]	August 2006

First pre-ballot draft: [items marked * need significant discussion in September, so a first pre-ballot may not be feasible for some of these items before then] o Chapter 5 Measurement – other issues o Chapter 6 Participating contracts * o Chapter 7 Changes in insurance liabilities * o Chapter 8 Other issues * o Appendices E-G [see enclosed draft chapter headings]	September 2006
Overview of the Board's tentative conclusions	September IASB meeting
Education session - presentation by the [European] CFO Forum, Group of North American Insurance Enterprises (GNAIE) and four leading Japanese life insurers	September IASB meeting
Participating contracts	September IASB meeting
Universal life contracts	September IASB meeting
Unit of account. Follow up of issues discussed in April.	September IASB meeting
Performance reporting (other than premium presentation)	September IASB meeting
Unbundling: should it be prohibited?	September IASB meeting
Long-term savings. Do conclusions reached for insurance contracts have implications for treatment of long-term savings contracts?	September IASB meeting
Sweep issues (if any) and other issues (if any) arising from the July meeting of the Insurance Working Group	September IASB meeting

Policyholder accounting. Should policyholder accounting be the subject of a separate discussion paper, or will it be sufficient to go straight to an exposure draft in due course?	September IASB meeting
Second pre-ballot draft	Late September / early October 2006
Sweep issues [if needed]	October 2006
Ballot draft	November 2006
Publication	December 2006

Appendix
Discussion paper – draft chapter headings

Chapter 1 Introduction

Chapter 2 Recognition and Derecognition

Chapter 3 Measurement – core issues

Chapter 4 Renewals, customer relationships

[including acquisition costs]

Chapter 5 Measurement – other issues

Chapter 6 Participating contracts

[including unit-linked and universal life, or put these in separate chapter[s]?]

Chapter 7 Changes in insurance liabilities

Chapter 8 Other issues

[eg Investment contracts]

Appendices

Appendix A Glossary [if needed]

Appendix B Draft guidance on cash flows

Appendix C Draft guidance on risk margins

Appendix D Issues not covered in this discussion paper

Appendix E Other relevant IASB projects

Appendix F Summary of the Board's preliminary views

Appendix G Summary of questions for respondents

Appendix H summary of proposals by some insurance trade association [and comparison with the Board's preliminary views]

AGENDA PAPER 8A Changes in insurance liabilities

Purpose of this paper

1. This paper discusses the following issue: When (if ever) should an insurer recognise premium receipts as revenue and when (if ever) should an insurer recognise them as deposit receipts?

2. The staff will ask the Board in September to consider whether an insurer should be required to present separately any specified components of the changes in the carrying amount of insurance liabilities. The Board is considering similar issues in other projects, notably in its work on financial instruments and on performance reporting.

Summary of recommendations

3. The staff recommends the following:

   (a) For shorter duration non-life contracts with a coverage period of no more than about one year, an insurer should recognise all premiums as revenue when earned, after unbundling any deposit component that is not closely related to the underlying insurance exposure. The staff will consider possible criteria for such unbundling when the FASB receives responses to its forthcoming invitation to comment on risk transfer. (paragraphs 21-22)

   (b) For all other insurance contracts, the Board should decide after the Discussion Paper to adopt one of the following, when the Board will have the benefit of responses to the IASB Discussion Paper on insurance contracts and to the FASB Invitation to Comment on insurance risk transfer:

      (i) require an insurer to treat all premiums as deposits, or

      (ii) require an insurer to unbundle all insurance contracts (paragraphs 19-20)

   (c) If the initial premium received exceeds the initial measurement of the insurance liability, the insurer should present that excess at inception as revenue, rather than as a gain.[1] The insurer should not offset that revenue against acquisition cost expense[2] (paragraphs 23-27).

[1] This paper address the **presentation** of revenue, but does not discuss the **timing** of revenue recognition.
[2] The Board has already reached the preliminary view that an insurer should recognise acquisition costs as an expense, not as an asset.

Background

4. The premium for an insurance contract could be viewed as made up of payments for the following:

   (a) The expected present value of payments to the small proportion of policyholders who incur insured losses.

   (b) Acquisition costs and the expected present value of other expenses.

   (c) A margin for bearing risk and providing other services.

   (d) If applicable, the expected present value of repayments to the same policyholders who paid the premiums (examples: annuities, endowments, some finite reinsurance contracts, some group insurance contracts). In substance, this component is a deposit. Significant deposit components are found in many longer term insurance contracts, particularly, but not exclusively, in life insurance.

5. This paper concentrates on the presentation of the portion of the premium that relates to the deposit component. Five possibilities could be considered:

   (a) Treat all premiums (including the portion that pays for the deposit component) for all insurance contracts as revenue.

   (b) For insurance contracts that meet specified criteria (perhaps life insurance contracts, or long duration contracts), treat all premiums for all contracts as deposits. For all other insurance contracts, treat all premiums (or perhaps all earned premiums, rather than written premiums) as revenue.

   (c) Permit insurers to choose for each class of insurance contracts between a revenue presentation and a deposit presentation, perhaps subject to some constraints.

   (d) For presentation in the income statement (even if not for recognition and measurement), unbundle some (or specified) insurance contracts into a deposit component and an insurance component.

   (e) Treat all premiums for all insurance contracts as deposits, and all claims and expenses as repayments of deposits.

6. Comments on these approaches:

(a) It would be inconsistent with the presentation of other kinds of activities (for example deposit taking by banks, or investment management by fund managers) to present deposit receipts as revenue and deposit repayments as an expense.

(b) If different models are used for different classes of insurance contract, the Board would need to define when each model is used. The definitions could target those contracts that are most likely to contain significant deposit components. However, we have so far identified no other reason to draw boundaries between different classes of insurance contracts. The boundaries might be arbitrary and difficult to define.

(c) Permitting insurers to choose between a revenue presentation and a deposit presentation may allow them to select the most appropriate presentation in each case, but could undermine comparability.

(d) Unbundling all or specified contracts into an insurance component and a deposit component avoids the disadvantages of a single on-off switch that creates a radical presentation difference in the presentation of income and expense. However, unbundling could be arbitrary and costly to perform. To minimise these disadvantages, unbundling could be targeted at contracts for which the benefits are most likely to exceed the costs. In May 2006, the FASB published an *Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, which seeks to gather information without presenting preliminary views. We can expect responses to that document to provide information on benefits and costs of unbundling.

(e) Presenting all premiums for all insurance contracts as deposit receipts would avoid the disadvantages of using an on-off switch to distinguish different types of contract. It would also avoid the costs of unbundling and avoid the need to determine how much of the original premium is earned (see paragraphs 13-17 for further discussion). However, it would be a significant change from current practice. It would also make it harder for users of non-life insurers' financial statements to derive commonly used ratios such as the claims ratio (claims expense divided by earned premium), expense ratio (expenses divided by earned premium) and combined ratio ([claims expense plus expenses] divided by earned premium). The specimen of a traditional non-life income statement in the appendix to this paper illustrates those ratios.

Does it matter?

7. Does it matter whether premiums are treated as revenue or deposits? The staff believes it does. Many insurers like to report total premium revenue as a headline indicator of the size of the business. Because they regard such indicators as helpful to users, some insurers, particularly life insurers, use adjusted measures of premium revenue to give what is, in their view, a more comprehensive measure of their size. For example:

   (a) Some life insurers report a performance metric they call 'annual premium equivalent'. This is the premium revenue for the year from recurring premium contracts plus 10% of the premium from single premium contract. The objective is to provide greater comparability between insurers with different ratios of single premium business to recurring premium business.

   (b) Some life insurers report performance metrics that combine premium revenue with non-revenue inflows (such as deposit receipts) for products such as mutual funds, long-term savings products and universal life contracts.

8. A cash flow statement prepared using the direct method might provide useful information, on a consistent basis, about inflows for savings-oriented products, regardless of whether they are insurance contracts, long-term savings contracts within the scope of IAS 39 or mutual funds.

9. In addition, some alleged abuses appear to have involved insurance or reinsurance accounting to account for significant deposit components, which resulted in allegedly misleading changes in performance metrics such as liabilities/premiums or combined ratios.

10. In summary, some insurers have devoted efforts to developing (and, allegedly, in some cases embellishing) performance metrics that are affected by reported revenue and expense. This suggests that insurers, and probably also users, view reported revenue and expense as important, and that it does matter whether premiums are treated as revenue or deposits.

Illustrations

11. To illustrate different presentations, the appendix to this paper shows how four different models could be applied:

(a) Typical **non-life insurance model**: Premiums received are recognised as a liability (unearned premium) and are then transferred to revenue as they are deemed to be earned.

(b) Typical **traditional life insurance model**: Premiums received are recognised immediately as revenue, and at the same time an addition to the liability is recognised as an expense.

(c) **Unbundled model**: Premiums received are recognised as a deposit receipt. Subsequently, amounts charged against a policyholder account balance for the provision of services are recognised as revenue. (If those charges are made in advance, they might be treated initially as unearned premium.) This approach is used mainly for universal life contracts (contracts with an explicit account balance and with flexible premiums and/or some non-guaranteed charges), and perhaps also for some reinsurance contracts with significant deposit components.

(d) **Margin model**: Premiums received are recognised as a deposit receipt. Subsequently, as the insurer is released from risk (and, if applicable, provides other services), the related portion of the risk margin amounts (and, if applicable, profit margin) is no longer needed and is recognised as revenue. A similar approach is often used by insurers to provide information about changes in embedded value (which is, in most cases reported outside the financial statements).

12. If the liability measurements are the same, these different approaches would have the same net effect on profit or loss, but the individual line items would differ.

Other comments

Non-linear patterns of risk

13. If part of all of the premium is treated as revenue, it is necessary to determine when the revenue should be viewed as earned. For many insurance contracts, that may reasonably be assumed to be on a straight-line basis, adjusted if the coverage varies seasonally (for example, insurance relating to winter sports). However, in some cases, it may be difficult to determine when premiums are earned, for instance if:

(a) the risk cannot be expressed easily as a simple linear factor (eg for some stop-loss contracts). For example, suppose a stop-loss contract covers 90% of aggregate losses during 2006 that exceed CU 10 million, up to a maximum payment of CU 9 million (ie 90% of aggregate losses in the layer between CU 10 million and CU 20 million).

The premium is, say, CU 1.2 million. If aggregate losses at 30 June are CU 5 million, how much of the premium is now earned?

(b) the risk fluctuates both up and down over time (eg for some types of guarantee). Suppose an equity-linked life insurance contract provides a death benefit equal to the higher of (i) the account value and (ii) 100% of the amount invested. The insurer charges an explicit or implicit additional premium of CU 1,000. How much of the premium is earned if the account value stands at (A) 130% of the amount invested? (B) 100% of the amount invested? (C) 70% of the amount invested? (D) What if the account value goes down to 70% of the amount invested and then goes back up to 100%?

(c) claims have long tails. For example, suppose a non-life insurer sells annual contracts, subject to large long-tail claims, some of which are not resolved for ten years. Should the insurer recognise the whole premium as revenue over the one year term of the contract (the traditional treatment)? Or should some of the premium be recognised in later years when the insurer is still bearing risk (which seems more consistent with the notion that an entity should recognise revenue from providing services when it provides the services)?

14. If all premium revenue is treated as a deposit, it is not necessary to determine when each portion of the original premium from the policyholder is earned.

Earned and unearned

15. One perhaps minor difference between the traditional non-life and traditional life presentation models relates to unearned premium. The non-life presentation recognises the premium received initially as a liability, and subsequently recognises it as revenue over time as it is earned. Conventionally, the unearned portion is viewed as deferred revenue, thought we might now view it as a cost-based measure of the stand-ready obligation.

16. In contrast, the traditional life model recognises premium receipts as revenue immediately when they are due, rather than later when they are earned. At the same time, the insurer recognises as an expense the resulting change in the liability. The net effect on profit is the same as in the non-life presentation, but the line items differ.

17. Why does this difference in presentation exist? One possible explanation is as follows: for a traditional one year non-life contract, the deposit component is relatively small and

it is reasonable to view most of the premium as a prepayment for a service. For long-duration life insurance contracts, the deposit component may be much more significant and it is likely to be more difficult to distinguish the portion of the premium that is a prepayment for future services from the portion that is, in substance, a deposit.[3]

Input from the Insurance Working Group

18. We have discussed aspects of income statement presentation with the Insurance Working Group several times. The following summary attempts to capture the range of views expressed by participants, without attempting to assess the extent of support for each statement:

    (a) US GAAP uses an unbundled model for universal life contracts. That model provides a useful insight into margins, but is difficult to apply to contracts that do not have explicitly unbundled charges. For these contracts, splitting premiums into a revenue component and a deposit component may be difficult and arbitrary.

    (b) Summary numbers indicating the size of the business are important. At present, quite similar items are presented differently: typically, insurance premiums are presented as revenue (with a corresponding expense), bank deposit receipts are presented as liability movements, funds received for management are not recognised at all. This diversity does not help. Comparability with banks is important, especially for entities that include both bank and insurance operations.

    (c) Combined ratios and similar ratios are important performance indicators for non-life contracts.

    (d) Although it may be difficult to define water-tight boundaries between different types of insurance contracts, it may not be important to have a single income statement presentation for all types of insurance contract.

    (e) The total of premiums, less surrenders and benefits, is a good measure of whether cash flow is positive.

    (f) Treating the entire premium as revenue is consistent with treating policyholder dividends as an expense.

[3] A reminder: the issue here is the presentation of premium receipts (ie as revenue or as deposits), not the measurement of the insurance liability. If the premium is recognised as revenue, there would still be an increase in the reported liability, and a corresponding expense.

(g) Existing income statement formats for life insurers in Europe are meaningless. A structured margin analysis is needed.

(h) A clear definition of revenue, and of the objective of reporting revenue, is needed before a decision can be made on how to present premiums.

(i) From a user's perspective, margin analysis required by FAS 97 is useful, but supplementary information on annual premium equivalents (see paragraph 7a) is also useful.

(j) It would not be helpful to distinguish life contracts from non-life contracts or short duration contracts from long duration contracts.

Staff recommendation

19. In principle, premiums relating to the deposit component of an insurance contract should be treated as deposit receipts, not as revenue, and related repayments should be treated as deposit repayments, not as expenses. The cleanest ways to achieve this are:

    (a) to treat all premiums for all insurance contracts as deposits, or

    (b) to unbundle all insurance contracts

20. The staff recommends that the Board wait until after the Discussion Paper stage before choosing between these alternatives. At that time, the Board will have the benefit of responses to the IASB Discussion Paper on insurance contracts and to the FASB Invitation to Comment on insurance risk transfer.

21. Users rely heavily on combined ratios and related ratios to assess an insurer's performance with non-life insurance contracts. Furthermore, for these contracts, except for longer-duration non-life contracts or cases of abuse, deposit components are typically less significant. On the other hand, reported instances of alleged abuse appear to have been more common in non-life, so deposit components may be more important if they have been inserted deliberately, rather than being a natural by-product of the insurance component.

22. On balance, the staff recommends the following: For shorter duration non-life contracts with a coverage period of no more than about one year, an insurer should recognise all premiums as revenue when earned, after unbundling any deposit component that is not closely related to the underlying insurance exposure. The staff will consider possible criteria for such unbundling when the FASB receives responses to its forthcoming invitation to comment on risk transfer.

Revenue and acquisition costs

23. Part of the premium paid by the policyholder compensates the insurer implicitly for acquisition costs incurred. In the traditional non-life presentation, acquisition costs are typically deferred and amortised over the period of insurance coverage. The premium (including the portion that implicitly pays for the acquisition costs) is also recognised as revenue over the coverage period. However, the Board has reached the preliminary view that acquisition costs are recognised as an expense when incurred and are not deferred. Similarly, the measurement of the liability does not include the portion of the premium that pays for the acquisition costs because that would not provide a measure of the remaining obligation. It follows that the insurer recognises this portion of the premium as income at inception.

24. To illustrate using the example in the appendix: the policyholder pays CU 1,000 and acquisition costs are CU 100. In the traditional non-life presentation, the initial measurement of the liability is CU 1,000 and the acquisition costs of CU 100 are deferred. However, applying the Board's preliminary views, the initial measurement of the liability is CU 900 and the insurer recognises acquisition cost expense of CU 100 and income of CU 100.

25. Should that income of CU 100 be described as revenue? If we regard an insurance contract as involving the service of bearing risk, some would argue that the insurer has not provided any service at the moment of inception, but rather provides that service over time; that view would lead to the conclusion that, at inception, IAS 18's criteria for recognising revenue from service contracts are not met. Therefore, supporters of that view might argue that the income of CU 100 is not revenue. Instead, they would present it as some other category of income, for example a gain.

Staff recommendation

26. The staff does not agree with that view. The customer paid CU 1,000, but only CU 900 is for the liability (as measured from the insurer's perspective, at least). The remaining CU 100 meets IAS 18's definition of revenue as the 'gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants'. Unless the definition of revenue is changed in the revenue project, the remaining CU 100 should be presented as revenue.[4] If the CU 100 is presented at

[4] Another reminder: This paper discusses how receipts from policyholders should be **presented**. It does not discuss **when** revenue (or other income) should be recognised.

inception as income, but not revenue, the cumulative revenue over the life of the contract will be only CU 900, not the CU 1,000 that the policyholder actually paid.

27. The excess of the initial premium received over the initial measurement of the liability (CU 100 in the example) should not be netted against the acquisition costs incurred. Netting would be inconsistent with normal offsetting restrictions in IFRSs and would obscure input information about the level of acquisition costs.

Appendix to agenda paper 8A: Illustrations

The following example is designed to illustrate the four presentation approaches discussed in paragraph 11. The focus is on the style of presentation and so the example has been kept as simple as possible. To make comparison easier, the same example is used for all four presentations. The example has the following features:

- Premium CU 1,000, covering insured events between 1 January and 31 December.
- Expected claims CU 700. CU 350 is paid on 30 June and CU 350 on 31 December.
- Acquisition costs CU 100, incurred on 1 January
- Other expenses associated with the administration of the contracts CU 80, incurred evenly through the period.
- Expected investment return 8% and risk free rate used to discount the liability cash flows 5%.
- The insurer estimates that there is no material gain or loss at inception (1 January). On 30 June, the insurer estimates that the appropriate margin is CU 69, which results in a liability measurement of CU 450 (coincidentally equal to a conventional unearned premium of CU 500 less conventional deferred acquisition costs of CU 50).
- No differences between actual outcomes and previous estimates.
- This illustration focuses on the presentation of premiums for a contract that does not include an explicit deposit component.

Traditional non-life income statement

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Premiums written	1,000		
Change in unearned premium	(1,000)	500	500
Premiums earned	0	500	500
Investment income		36	22
Claims		350	350
Expenses		40	40
Acquisition costs		50	50
Total expenses	0	440	440
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	
Equity	0	96	178
Claims ratio		70%	70%
Expense ratio		8%	8%
Combined ratio		78%	78%

Comments:

1. Premiums written are the premiums that became payable during the period (almost a cash basis). Premiums earned are the premiums written, less the portion considered unearned). Many non-life insurers use this two-stage presentation of premiums.

2. The line for acquisition costs shown here relates to amortisation of acquisition costs of CU 100 incurred at inception. This style of presentation is not fully consistent with the measurement model, because acquisition costs are not deferred. An alternative presentation would show acquisition costs of CU 100 as an expense at inception, earned premium revenue of CU 100 at inception and earned premium revenue of CU 450 (instead of CU 500) in each six month period. However, some may feel that none of the premium revenue is really 'earned' at inception.

Traditional life income statement

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Premium revenue	1,000		
Investment income		36	22
Total income	1,000	36	22
Claims		350	350
Change in insurance liability	900	(450)	(450)
Expenses		40	40
Acquisition costs	100		
Total expenses	1,000	(60)	(60)
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	
Equity	0	96	178

Comments:

1. The line ‘change in insurance liability’ does not seem particularly helpful because it shows the result of a computation, not the effect of a real economic event.

2. This presentation does not require the insurer to analyse the reasons for changes in the liability. Such analysis may be complex for traditional products that bundle together many elements.

Unbundled presentation

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Charges to policyholder account	-	473	461
Policyholder benefits	-	(350)	(350)
Expenses	-	(40	(40)
Insurance margin		83	71
Gain at inception	100		
Acquisition costs	(100)		
Net gain at inception	0	0	0
Investment income		36	22
Interest on insurance liability		(23)	(11)
Net interest and investment	0	14	11
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	-
Equity	0	96	178

Comments:

1. This format:

   (a) treats all premiums as deposits (except the portion needed to pay for acquisition costs).

   (b) subsequently presents as revenue the explicit or implicit charges made to policyholder accounts.

2. In US GAAP, a somewhat similar presentation is used for universal life contracts. This format is possible for these contracts because the design of the contract unbundles the different contract elements. This approach may be more challenging if charges to policyholders are implicitly bundled into a premium, rather than identified explicitly.

3. In this illustration, there is no explicit policyholder account and, hence, no explicit charge. The amounts shown as policyholder charges are implicit and are computed as the expected value of policyholder benefits and expenses, plus the risk margin (and, if applicable, profit margin) released in the period. (The margin presentation that follows next shows as revenue only the release of those margins.)

Margin presentation

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Insurance margin		83	71
Gain at inception	100		
Acquisition costs	(100)		
Net gain at inception	0	0	0
Investment income		36	22
Interest on insurance liability		(23)	(11)
Net interest and investment	0	14	11
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	-
Equity	0	96	178

Comments:

1. This format is similar to the analysis of movements in embedded value provided by many larger life insurers in the UK, Continental Europe, Australia, Canada and South Africa, and to the 'sources of earnings analysis' provided by some Canadian life insurers.

2. This format treats all premiums as deposits, and all claims expense, claims handling expense and other contract-related expense as repayments of deposits.

3. 'Release of margins' refers to the difference between the margin at the start of the period and the margin at the end of the period. It reports the estimated margin that market participants would have required at the start of the period for bearing risk during the period.

AGENDA PAPER 8B Unit-linked and index-linked payments

Purpose of this paper

1. This paper discusses the following issues relating to the measurement of policyholder payments that are denominated in terms of an internal or external investment fund (unit-linked payments) or an index:

   (a) Recognition and presentation of separate account assets (paragraphs 8-22)

   (b) Measurement of separate account assets (paragraphs 23-35)

   (c) Measurement of assets held to back index-linked payments (paragraphs 36 and 37)

Summary of recommendations

2. The staff recommends the following:

   (a) An insurer should recognise separate account assets, and the related obligation to pay policyholder benefits, unless the insurer has a contractual obligation to pay all cash flows from the separate account assets to the separate account policyholders (a 'pass-through' obligation). An insurer has a pass-through obligation if it meets the four criteria described in paragraph 14. (paragraphs 14-22)

   (b) If the cash flows for a liability (or portion of a liability) are determined solely by the fair value of a specified pool of assets that would necessarily be delivered in any transfer of that portion of the liability, the current exit value of that liability (portion) is consistent with the carrying amount of those assets. (paragraph 23-34)

   (c) This project should not change the measurement requirements for owner-occupied property held in a unit-linked fund. (paragraphs 28 and 35)

   (d) This project should not change the measurement requirements for assets that are held to hedge an index-linked liability (ie liability that is contractually linked to an index, but where the insurer (or other issuer) is not contractually required to hold the underlying assets). Moreover, if the insurer does hold the underlying asset but does not measure it at fair value through profit or loss, that fact should not affect the carrying amount of the liability. (paragraph 36 and 37)

Background

3. In some insurance contracts, some or all of the policyholder benefits are contractually determined by the price of units in an internal or external investment fund (ie a designated pool of assets held by the insurer or a third party and operated in a way similar to a mutual fund). This paper describes these contracts as **unit-linked contracts**, the benefits that are determined by the unit prices as **unit-linked benefits** and the pool of assets as a **unit-linked fund** (regardless of the legal form of the pool). In some countries, such countries have other names, for example variable contracts.

4. For convenience, this paper uses the terms **separate account** assets to describe assets for which policyholders bear all the investment risk (other than indirect risk relating to future investment management fees and to investment guarantees) and **general account** assets for all of an insurer's other assets.

5. Unit-linked contracts can be insurance contracts or investment contracts, depending on whether the contract transfers significant insurance risk. 'Investment contract' is an informal name for a contract that does not transfer significant insurance risk.

6. Unit-linked contracts typically have most or all of the following features:

   (a) the premium received from the policyholder is used to buy units in a fund, in some cases after the insurer has deducted a front-end fee or a bid-ask spread.

   (b) The unit price at any time reflects the fair value of the assets held in the fund, possibly adjusted for a bid-ask spread.

   (c) Charges are deducted from the fund (as a whole) for investment management, administrative and other expenses and tax.

   (d) Other charges are often made to individual policyholder's account for insurance coverage (eg a fee for mortality protection), and perhaps also for contract administration and as a means of recovering acquisition costs. These charges are typically determined as a monetary amount, with units cancelled to provide that amount (number of units cancelled equals the monetary amount, divided by the unit price). In some cases, the charges are levied by issuing special sub-classes of units that do not pass through all investment performance (eg where 'capital units' are used as a means of recovering acquisition costs)

(e) Depending on the structure and legal setup, the assets in the fund may or may not be insulated from the insurer's other activities. If the assets are not insulated, this may be an important difference from most mutual funds.

(f) A unit-linked contract may provide both unit-linked benefits and other non-unit benefits (eg life coverage). This paper deals only with the unit-linked benefits. The general principles being developed in the rest of this project would apply to the non-unit benefits.

(g) Insurers often provide some guarantees related to the investment performance of unit-linked benefits.

7. This paper does not address the following topics, because they are addressed by the general requirements we are developing for all insurance contracts:

(a) Revenue recognition relating to charges made to unit-linked policyholders. (In April, the Board concluded that the current exit value of an insurance liability would incorporate the margin that market participants would require for providing other services. It follows that the insurer would recognise the charges to policyholders as revenue when earned, unless they are out of line with charges by other market participants).

(b) Customer relationships associated with the contract (included in the measurement to the extent the policyholder would lose guaranteed insurability if the policyholder either stops paying premiums or surrenders the contract).

(c) Measurement of guarantees related to the investment performance of unit-linked benefits. These would be measured at current exit value (if the guarantee meets the definition of an insurance contract) or fair value (if the guarantee is a financial instrument)

Recognition and presentation of separate account assets

8. The first question to consider is whether the separate account assets are an asset of the insurer and the related portion of the liability is a liability, or whether they should be treated in the same way as assets managed by a fund manager (ie off balance sheet). For unit-linked contracts, the contract holder derives the direct benefits from the investment performance of the separate account assets, and bears the investment risk associated with those assets. The issuer derives indirect benefits from the assets in the form of explicit or implicit investment management fees. If the issuer has given guarantees of investment

performance, the issuer also derives indirect benefit from investment performance and bears some of the investment risk as guarantor.[5]

9. The appendix to this paper illustrates three treatments for separate account assets:

   (a) Exclude the separate account assets from the issuer's balance sheet and exclude the related portion of the liabilities.

   (b) Include the separate account assets in the issuer's balance sheet as a single line item separate from the issuer's general account assets, and include the entire liability as another line item.

   (c) Include in the issuer's balance sheet the separate account assets, commingled with the issuer's general account assets, and include the entire liability as another line item.

10. The first approach excludes the separate account assets (and the related portion[6] of the liabilities) from the issuer's balance sheet. Arguments for this approach:

    (a) In substance, the assets are held for the beneficial interest of the contract holders.

    (b) In some cases, the assets are not available to the insurer for general business purposes.

    (c) This treatment is consistent with the way that an asset manager accounts for funds that it manages.

    (d) This approach eliminates accounting mismatches that could occur if the unit-linked assets are not measured at fair value through profit or loss (see paragraphs 23-35).

11. The second approach includes the separate account assets as a single line item separate from the issuer's general account assets and includes the entire liability as another line item. Arguments for this approach:

    (a) Arguably, the insurer controls the assets.

    (b) Excluding part of the insurer's obligation from the insurer's balance sheet is not appropriate if the insurer is required to satisfy the entire obligation.

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[5] In some cases, the issuer is charges an explicit fee for the guarantee. In other cases, there is no separate fee for the guarantee and the issuer aims to achieve a satisfactory return from the contract as a whole.

[6] The related portion of the liabilities is the portion of the liabilities that depends directly on the performance of the assets. If the liability includes other portions (eg guarantees of investment performance or additional death benefits), these would still be recognised.

(c) The single-line presentation is helpful for users because it distinguishes assets for which the policyholders bear all the investment risk from the insurer's other assets.

12. The third approach commingles the separate account assets with the issuer's general account assets. Arguments for this approach:

(a) Arguably, the insurer controls the assets.

(b) Reporting part of the insurer's obligation off balance sheet is not appropriate if the insurer is required to satisfy the entire obligation.

Criteria to define separate account assets

13. If the first or second approach is adopted, it would be necessary to define when that approach is available. One possible approach would build on the notion of a 'pass-through' obligation, as used in IAS 39 for derecognition purposes. For illustrative purposes, the pass-through notion might be implemented using the wording in the following paragraph:

14. An insurer shall recognise separate account assets, and the related obligation to pay policyholder benefits, unless the insurer has a contractual obligation to pay all cash flows from the separate account assets to the separate account policyholders (a 'pass-through' obligation). An insurer has a pass-through obligation if it meets the following four criteria, based on the derecognition criteria for pass-through arrangements in paragraphs 19 and 20 of IAS 39:[7]

(a) The insurer has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the separate account assets. This condition is not breached if the insurer provides such benefits as guarantees of investment performance or guaranteed minimum death benefits, but the insurer would need to recognise its stand-ready obligation to provide those benefits, and measure that obligation at current exit value (if the guarantee meets the definition of an insurance contract) or fair value (if the guarantee is a financial instrument).

(b) Contract, law or regulation, prohibit the entity from selling, pledging or lending the separate account assets except for the benefit of the separate account policyholders (even in bankruptcy).

[7] Paragraphs BC54-BC64 of the basis for conclusions on IAS 39 describe the rationale for these criteria.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows outside the separate account, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the separate account, and interest earned on such investments is passed to the separate account.

(d) The insurer has substantially none of the risks and rewards of ownership of the separate account assets (other than the right to collect fees for providing investment management services and risk related to guarantees of investment performance).

15. The following paragraphs discuss selected aspects of the criteria in paragraph 14

(a) Bankruptcy remoteness (paragraph 17)

(b) Guarantees (paragraph 18)

16. Appendix B compares the four criteria in paragraph 14 with the corresponding criteria in IAS 39.

Bankruptcy

17. The Board discussed the approach in paragraph 14 in April. The Board instructed the staff to continue working on this approach and to consider how the proposed criteria might operate in bankruptcy. We need to consider two types bankruptcy: (a) of the issuer itself (b) of the unit-linked fund.

(a) Bankruptcy of the issuer: Criterion (b) in paragraph 14 prevents the insurer itself or its creditors from benefiting from the unit-linked assets, even in bankruptcy.

(b) Bankruptcy of the unit-linked fund. Criterion (a) in paragraph 14 means that the insurer has no obligation to pay policyholders if the assets of the fund are insufficient (leaving aside any separately recognised guarantees of investment performance). Thus, in relation to the fund itself, the notion of bankruptcy is not really applicable, unless the assets of the fund are stolen or lost. If that occurs, the issuer might have a responsibility, as custodian, to make good the loss. However, similar responsibilities are not generally viewed as requiring a custodian to recognise third party funds under management.

Guarantees

18. The source wording in IAS 39 is for use when an entity is assessing whether it should derecognise an asset that it already recognises. Therefore, that wording does not permit derecognition if the entity retains a risk by guaranteeing the performance of the transferred assets. In contrast, the wording in paragraph 14 would apply when an entity is assessing whether it should recognise separate accounts and related liabilities for the first time; that wording does not exclude cases where the insurer provides a guarantee of the investment performance (provided the insurer recognises that guarantee).

Staff recommendation on separate accounts

19. The staff recommends that an insurer should recognise separate account assets, and the related obligation to pay policyholder benefits, unless the insurer has a contractual obligation to pay all cash flows from the separate account assets to the policyholders (a pass-through obligation). An insurer has a pass-through obligation if it meets the criteria in paragraph 14.

20. If the Board concludes that an insurer should recognise pass-through obligations and related separate account assets, the staff recommends that the insurer should present those separate account assets as a single line item, separate from its general account assets.

21. The staff does not recommend presentation as a single line item when the criteria in paragraph 14 are not met.

Related issue not discussed in this paper

22. This paper does not discuss whether investments held through separate account arrangements are relevant in assessing whether an insurer controls (or significantly influences) an investee. This question might arise if, for example, an insurer holds 10% of an investee through its general account and 45% through one or several separate accounts.

Measurement of separate account assets

23. In most countries, insurers measure assets in unit-linked funds at fair value and measure the unit-linked benefits on a similar basis: if the obligation is to pay benefits equal to 100 units, the benefit is measured at 100 times the current unit price.

24. In May, the Board noted that accounting mismatches can arise if some or all of the unit-linked assets:

(a) cannot be recognised. This might occur if the unit-linked assets include shares or financial liabilities of the issuer itself (treasury shares) or goodwill in subsidiaries

(b) are recognised, but cannot be measured at fair value. This might occur if the assets meet the definition of inventories in IAS 2 ('assets held for sale [..] in the ordinary course of business […]'), in which case they are measured at the lower of cost and net realisable value. (Commodity broker-traders may measure their inventories at fair value less costs to sell)

(c) are measured at fair value, but changes in their fair value must be recognised outside profit or loss. This might occur if a unit-linked fund owns a building that is rented to the insurer for use in its own operations. The building would be an owner-occupied property within the scope of IAS 16 *Property Plant and Equipment*.

25. The Board suggested in May that it would be preferable to avoid these mismatches, if all else were equal. However, Board members had different views on whether and how to eliminate these mismatches. For example, in relation to the example of treasury shares:

(a) Some Board members favoured the recognition of the treasury shares.

(b) Other Board members favoured an adjustment to the measurement of unit-linked liabilities to exclude the portion of the policyholder benefits that depends directly on the fair value of the insurer's own shares held by the fund.

(c) Finally, other Board members concluded that there is no acceptable approach that could eliminate the accounting mismatch.

26. The following paragraphs discuss the advantages and disadvantages of these alternatives. The first point to make is that the accounting mismatch does not exist if the insurer does not recognise the unit-linked assets and the related portion of the obligations. IN other words, if the Board accepts the recommendation in paragraph 19, the need to consider ways of eliminating the accounting mismatch may be much reduced, and perhaps eliminated.

Recognition and measurement criteria for unit-linked assets

27. One suggestion during the Board's discussion in May was to extend the fair value option currently in IAS 39 so that it could be used for all unit-linked assets, financial or non-financial. This approach would have the advantage of building on a treatment that

already exists. It would seem most relevant for owner-occupied property. However, it would not be sufficient to eliminate the measurement mismatch for:

(a) treasury shares. Treasury shares do not meet the definition of an asset from the perspective of the insurer as a whole. Therefore, recognising them as an asset would not be appropriate.

(b) internally generated goodwill in subsidiaries. Internally generated goodwill does not qualify for recognition as an asset under existing IFRSs. Introducing an exception to that requirement for this particular class of goodwill would be confusing, especially if part of the goodwill is held in the unit-linked fund and part is held by the insurer itself. If such a requirement is introduced, it will be necessary to decide whether the insurer should recognise the internally recognised goodwill in full or only to the extent of the policyholders' interest.

(c) acquired goodwill in subsidiaries. Although acquired goodwill is recognised, any subsequent remeasurement is likely to incorporate internally generated goodwill.

Specific exception for owner-occupied property

28. Another approach would introduce a fair value option for owner-occupied property held as a unit-linked asset. The staff does not favour this approach because it does not rely on a general principle.

Measurement of the liability

29. In May, the staff suggested the following approach: if the assets of a unit-linked fund cannot (even using all available accounting options) be recognised and measured at fair value, the insurer should adjust the carrying amount of the liabilities to exclude the portion of the benefit that depends directly on the difference between the carrying amount of the assets and their fair value. The staff emphasised that this recommendation was **only** for cases in which there can be no material leakage of cash out of, or into the fund.

30. Some Board members were reluctant to endorse this approach because they viewed this adjustment as an ad hoc and rule-based over-ride of a general measurement principle (current exit value).

31. The staff now believes that this approach can be viewed as an application of the current exit value principle, rather than a modification of it. Because the pay-outs on the unit-linked liability are directly linked to the fair value of the assets, it is inconceivable that a transfer of the liability could occur without a transfer of the linked assets.

32. For example, consider a unit-linked fund that holds treasury shares (ie the insurer's own shares) with a fair value of CU 50 and other financial instruments with a fair value (and carrying amount) of CU 950. For simplicity, assume that the contracts carry no investment guarantees and that the current exit value of the remaining contractual rights and obligations is negligible. A hypothetical transfer of the unit-linked liabilities would involve a transfer of both the assets and the liabilities for a net price of zero. Put differently, the insurer would pay for the transfer of the liabilities by delivering treasury shares with a carrying amount of zero and other assets with a fair value of CU 950. There are no circumstances in which the obligation to deliver the treasury shares could cause a loss to the insurer.[8] Indeed, if the treasury shares were sold immediately before the transfer, and the proceeds were reinvested in other assets, the insurer would still have to deliver a pool of assets with the same fair value (but a different composition); however, although that pool of assets would now have a carrying amount of CU 1,000, the insurer would not have suffered any economic loss.

33. The staff recommends the following: If the cash flows for a liability (or portion of a liability) are determined solely by the fair value of a specified pool of assets that would necessarily be delivered in any transfer of that portion of the liability, the current exit value of that liability (portion) is consistent with the carrying amount of those assets.

34. This paper proposes two different sets of criteria. Paragraph 14 proposes criteria that separate accounts must satisfy if they are not to be recognised at all, or recognised but as a single line item. Paragraph 33 proposes criteria relating to determining the current exit value of a unit-linked liability. The two sets of criteria differ because they were developed with different objectives in mind. However, it seems likely that both sets of criteria would often have the same result in practice. If the Board agrees with the recommendations in this paper, we intend to seek feedback from the Insurance Working Group to help us assess whether the criteria can be streamlined and perhaps combined.

35. The staff recommendation would not eliminate the accounting mismatch for owner-occupied property. That mismatch arises not from different measurements but from different treatments of changes in carrying amount.

Measurement of assets held to back index-linked payments

36. In some cases, an insurance liability or financial liability is linked to an index, but the insurer (or other issuer) is not contractually required to hold the underlying assets, though

[8] Any guarantees of investment performance would be measured at current exit value.

it may choose to do so to hedge the liability. Some argue that the liability should be treated in the same way as unit-linked liabilities, as discussed above.

37. The staff does not recommend that approach. In this case, the insurer is not compelled to hold the underlying assets and it could transfer the liability without a simultaneous transfer of the assets. Therefore, the carrying amount of the underlying assets (if held) is irrelevant in determining the current exit value of the liability. Moreover, introducing exceptions to normal recognition and measurement criteria for the underlying assets (if held) would create a need for definitions, criteria and perhaps even a new form of hedge accounting.

Appendix A

Consolidation and presentation of unit-linked contracts and separate accounts – example

An insurer has a pool of assets dedicated to unit-linked contracts. The pool comprises bonds with a fair value of CU[9] 1,000 and equities with a fair value of CU 500. The unit value of the liabilities is CU 1,500. Also, the unit-linked liabilities carry investment guarantees, which have a current exit value of CU 37. In addition, the insurer has other (non-linked) insurance liabilities with a current exit value of CU 4,000 and its other assets are bonds (fair value CU 2,500) and equities (fair value CU 2,000).

The example shows the following three styles of presentation.

(a) Presentation similar to a mutual fund: the insurer does not recognise the pool of assets or the related unit liabilities. It does recognise the investment guarantee.

(b) Separate account: the insurer recognises the pool of assets and related unit liabilities. The pool of assets is recognised as a single line item.

(c) Commingled: Separate account: the insurer recognises the pool of assets and related unit liabilities. The pool of assets is commingled with the insurer's other assets.

	Mutual fund	*Separate account*	*Commingled*
Investments - bonds	2,500	2,500	3,500
Investments - equities	2,000	2,000	2,500
Investments - separate account		1,500	
Total assets	4,500	6,000	6,000
Unit-linked liabilities		1,500	1,500
Guarantees of unit-linked liabilities	37	37	37
Other insurance liabilities	4,000	4,000	4,000
Total liabilities	4,037	5,537	5,537
Equity	463	463	463

[9] CU = currency units

Appendix B

Pass-through obligations

The following table compares the proposed pass-through criteria (see paragraph 14) with the criteria in paragraphs 19 and 20 of IAS 39. Emphasis has been added to **highlight** differences between the two sets of criteria.

Criteria proposed in this paper	**Criteria in IAS 39**
An insurer shall recognise separate account assets, and the related obligation to pay policyholder benefits, unless the insurer has a contractual obligation to pay all cash flows from the separate account assets to the separate account policyholders (a 'pass-through' obligation). An insurer has a pass-through obligation if it meets the following four criteria	19. When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.
(a) The insurer has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the separate account assets. **This condition is not breached if the insurer provides such benefits as guarantees of investment performance or guaranteed minimum death benefits, but the insurer would need to recognise its stand-ready obligation to provide those benefits, and measure that obligation at current exit value (if the guarantee meets the definition of an insurance contract) or fair value (if the guarantee is a financial instrument).**	(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. **Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.**
(b) Contract, **law or regulation**, prohibit the entity from selling, pledging or **lending** the separate account assets except **for the benefit of the** separate account policyholders	(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the

(**even in bankruptcy**).	obligation to pay them cash flows.
(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows **outside the separate account**, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance **to the separate account**, and interest earned on such investments is passed to the **separate account**.	(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IAS 7 *Cash Flow Statements*) during the short settlement period from the collection date to the date of required remittance **to the eventual recipients**, and interest earned on such investments is passed to the **eventual recipients**.
(d) The insurer has substantially none of the risks and rewards of ownership of the separate account assets (**other than the right to collect fees for providing investment management services and risk related to guarantees of investment performance**).	20. When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case: (a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer. (b) […]