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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: **25 January 2007, London**

Project: **Insurance contracts (phase II)**

Subject: **Policyholder participation rights - example (Agenda paper 10B)**

Purpose of this paper

1. The Board has tentatively concluded that an insurer should classify the participating component of a participating contract as a liability only to the extent that the insurer has an enforceable obligation. This paper illustrates how that conclusion affects the presentation of an insurer's financial statements. This example was previously in Agenda paper 12F for the IASB meeting in September 2006. This paper does not include recommendations.

Fact pattern for the example

2. As always, we have simplified facts to restrict the example to the most relevant features for the question we are considering. As a result, the example is artificial. Insurer A issues participating insurance contracts, with the following features:

   (a) Each policyholder pays a single premium of CU 1,000 on 1 January.

   (b) If the policyholder dies in the next two years, the contract pays a death benefit of CU 20,000.

(c) The contract ends after two years. If the policyholder survives to the end of the second year, there is no fixed maturity benefit, but the policyholder is eligible to receive a dividend if the insurer declares one. The insurer has typically paid policyholder dividends of around 90% of the surplus attributable to maturing contracts and, at the same time paid a dividend of around 10% of that surplus to shareholders. The insurer expects this practice to continue for the foreseeable future. However, the insurer believes it has no enforceable legal or constructive obligation to pay any benefit whatsoever to policyholders or shareholders.

(d) The insurer issues 1,000 contracts on each of 1 January x2, 1 January x3 and 1 January x5. On 1 January x4, the insurer issues 1,800 contracts.

(e) 1% of the original number of policyholders die each year. For example, for contracts that started on 1 January x2, 10 policyholders die in x2 and 10 die in x3. For contracts that started on 1 January x4, 18 policyholders die in x4 and 18 die in x5.

(f) There are no lapses, acquisition costs, running costs, taxes, or differences between actual experience and previous estimates. Investment returns and risk margins are ignored.

3. The following tables summarise the insurer's balance sheet, income statement and cash flows, applying the Board's tentative decisions (all figures in CU'000):

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder dividends	(540)	(540)	(972)
Profit	60	540	(372)

Changes in equity

	x3	*x4*	*x5*
Opening equity	600	600	1,080
Profit	60	540	(372)
Shareholder dividends	(60)	(60)	(108)
Closing equity	600	1,080	600

Cash flow statement

	x3	*x4*	*x5*
Premiums	1,000	1,800	1,000
Death benefits	(400)	(560)	(560)
Policyholder dividends	(540)	(540)	(972)
Shareholder dividends	(60)	(60)	(108)
Net cash inflow (outflow)	0	640	(640)
Opening cash	800	800	1,440
Closing cash	800	1,440	800

4. There are two striking things about this example:

   (a) Insurer A collects premiums in the first year of the contract but expects to pay some of the premiums back to policyholders in the second year. Nevertheless, insurer A does not recognise as a liability the dividends it expects to pay to policyholders.

   (b) Insurer A recognises profits in one period, followed by losses in another period. These effects would balance out in aggregate if the insurer is in a

steady state. However, if the insurer is contracting, or expanding, or fluctuating in size, the effects will not balance out.

5. We can see these effects most clearly by looking at the contracts issued in x4. For these contracts:

   (a) Insurer A collects CU 1,800 at the start of x4, pays benefits of CU 360 in each of x4 and x5 and repays CU 972 to policyholders at the end of x4. This leaves CU 108 available as a dividend for shareholders. At the end of x4, although insurer A expects to pay policyholders CU 1,332 (death benefits of CU 360 plus dividends of CU 972) it recognises a liability of only CU 360.

   (b) In x4, insurer A recognises revenue of CU 1,800 and expenses of CU 720 (actual death benefits of CU 360 for x4 and expected death benefits of CU 360 for x5), leading to a profit of CU 1,080 from these contracts. In x5, insurer A recognises a loss of CU 972 on these contracts. The profit of CU 1,080 in x4 comprises the CU 972 that insurer A expects to return to policyholders in x5 and CU 108 profit for the shareholders.

6. The appendix to this paper illustrates how this example would look using three alternative approaches that the Board rejected in March 2006:

   (a) Highlight, on the face of the balance sheet and income statement, the portion of equity and profit that is expected to be returned ultimately to policyholders.

   (b) Use split accounting, similar to IAS 32's treatment of compound instruments, such as convertible debt.

   (c) Include in the measurement of the liability all cash flows that are expected to go ultimately to current or future policyholders.

Appendix

Example – other methods

Alternative method 1: Same as the Board's tentative conclusions, but highlight policyholder equity and policyholder profit

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Analysis of equity on the face

Policyholder equity	540	972	540
Shareholder equity	60	108	60
Total equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder dividends	(540)	(540)	(972)
Profit	60	540	(372)

Analysis of profit on the face

Policyholder profit	-	432	(432)
Shareholder profit	60	108	60
Total profit	60	540	(372)

Notes:

1. This approach is an extension of the approach that the Board has tentatively adopted. It provides analysis, on the face of the balance sheet and income statement, of the equity and profit. In all other respects, the Board's tentative conclusions are consistent with this approach.

2. Policyholder profit in x4 is the policyholder equity at the end of x4 (CU 972), less the policyholder dividend of CU 540.

3. Shareholder profit is higher in x4 than in x3 and x5 because more contracts were issued. In this example, risk margins were excluded for simplicity, and the time value of money was ignored. As a result, in this artificial example, all shareholder profit is recognised in the first year.

Changes in equity

	x3	*x4*	*x5*
Opening equity	600	600	1,080

Profit	60	540	(372)
Shareholder dividends	(60)	(60)	(108)
Closing equity	600	1,080	600

Alternative method 2: classify expected policyholders dividends as a liability

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities: guaranteed benefits	(200)	(360)	(200)
Policyholder liabilities: participation benefits	(540)	(972)	(540)
Equity	60	108	60

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder participation	(540)	(972)	(540)
Profit	60	108	60

Changes in equity

	x3	*x4*	*x5*
Opening equity	60	60	108
Profit	60	108	60
Shareholder dividends	(60)	(60)	(108)
Closing equity	60	108	60

Alternative method 3: split accounting

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Analysis of equity

Policyholder equity	540	972	540
Shareholder equity	60	108	60
Total equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	460	828	460
Policyholder benefits	(400)	(720)	(400)
Profit	60	108	60

Changes in policyholder equity

	x3	*x4*	*x5*
Opening	540	540	972
Proceeds of new contracts	540	972	540
Policyholder dividends	(60)	(540)	(972)
Closing	540	972	540

Changes in shareholder equity

	x3	*x4*	*x5*
Opening	60	60	108
Profit	60	108	60
Shareholder dividends	(60)	(60)	(108)
Closing	60	108	60