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Project	<b>Insurance Contracts</b>
Topic	<b>Participating investment contracts</b>

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## Introduction

1. This paper discusses whether investment contracts with a discretionary participation feature (dpf) should be within the scope of a standard on:
  - (a) insurance contracts and so be measured in the same way as participating insurance contracts, or
  - (b) financial instruments (FI) and so measured at amortised cost or fair value through profit or loss [IASB] or fair value through profit or loss or other comprehensive income (OCI) [FASB].

## Staff recommendation

2. Staff recommend that:
  - (a) The IASB adopts view 1, ie that participating investment contracts should be within the scope of the future IFRS on insurance contracts and measured in the same way as participating insurance contracts.
  - (b) The FASB adopts view 2, ie that these financial instruments should be in the scope of the future FI standard and measured in the same way as financial instruments.

## Structure of the paper

3. This paper is divided into the following sections:
  - (a) Background (paragraphs 4 –17).
  - (b) Alternative approaches (paragraphs 18 – 24).
  - (c) View 1 (paragraphs 25-30).
  - (d) View 2 (paragraph 31).
  - (e) Staff recommendations (paragraphs 32-35).

- (f) Appendix A - extracts from IFRS 4 *Insurance*.

## Background

### *What are participating investment contracts?*

4. In this paper, an *investment contract* refers informally to a financial instrument; a *participating investment contract* is a generic and informal term for a financial instrument that provides the holder with some participation in the performance of a pool of assets (or profit or loss of the company, fund or other entity that issues the contract), with the participation operating in a way similar to participating insurance contracts.
5. More specifically, the IASB defined a subset of these contracts in IFRS 4 *Insurance Contracts* by referring to a *discretionary participation feature* (dpf), defined as:

A contractual right to receive, as a supplement to **guaranteed benefits**, additional benefits:

- (a) that are likely to be a significant portion of the total contractual benefits;
- (b) whose amount or timing is contractually at the discretion of the issuer; and
- (c) that are contractually based on:
  - (i) the performance of a specified pool of contracts or a specified type of contract;
  - (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
  - (iii) the profit or loss of the company, fund or other entity that issues the contract.

IFRS 4 defines guaranteed benefits as payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

6. The term dpf did not exist before IFRS 4. The IASB created this term to capture the feature that makes it difficult to account for these features: a form of participation that is subject to constrained discretion, ie a combination of discretion and constraints on that discretion.
7. Participating investment contracts, known in some countries as *with-profits* contracts, are issued predominantly by life insurers as general investment /

savings vehicles to enable contract holders to participate in the performance of designated assets held by the insurer. Sometimes, assets for both participating insurance and investment contracts are held in the same with-profits fund and both types of contract share in the profits of the fund.

8. In practice these contracts vary widely in terms of structure and complexity due to legal or regulatory requirements. They share, however, the following key characteristics with participating insurance contracts:
  - (a) The amounts paid to contract holders are contractually linked to the performance of a pool of underlying assets (held by the issuer) usually equities, bonds and property and comprise **guaranteed benefits** (as specified at contract inception) and **additional benefits**.
  - (b) The issuer has some discretion over the amount and/or timing of additional benefits to contract holders, although that discretion may be subject to contractual constraints (legal, regulatory or competitive).
  - (c) Although the issuer has contractual discretion over the distribution of additional benefits, it is common practice that current or future contract holders will ultimately receive some part of the accumulated surplus available at the reporting date for distribution to contract holders.

*Why do investment contracts with dpfs exist?*

9. Investment contracts with dpfs enable contract holders to share in the performance of a pool of assets in a manner that smoothes the investment return over time so that contract holders are not exposed to volatility as directly as they are in unit-linked (variable) contracts. No precise formula dictates how the smoothing mechanism operates and the issuer generally has some discretion over it. The extent of that discretion, and of the constraints on that discretion, vary geographically and to a degree also from case to case.
10. If the actual return on investment *matches expectation*, the insurer expects to pass some or all of the surplus back to contract holders (but retains some contractual discretion over the amount and/or timing of the total amount distributed to all contract holders and over how that amount is allocated to particular generations of contract holders).

11. If the actual return on investment *is worse* than expected, the additional amount distributed to contract holders would be reduced, or not even made at all. If the actual investment returns are below the guaranteed benefits, the shortfall results in a loss to the insurer.
12. As a result of these features, it is often useful to think of a participating contract as containing a combination of several elements, for example:
  - (a) a proportionate interest in the underlying assets
  - (b) a share in assets producing cash flows equal to the guaranteed benefits
  - (c) an option, written by the issuer, permitting the contract holder to put the interest in the underlying assets to the issuer for a fixed strike price equal to the guaranteed benefits
  - (d) other options, such as surrender options, conversion options, options to make the contract paid up (ie to stop paying premiums but still receive some benefits).

*What types of dpf exist?*

13. There are many different types of dpf, as highlighted in agenda paper 6I (FASB memo 41I) on participating insurance contracts discussed at the March joint meeting. Some common types, which are also found in dpf in investment contracts, include the following:
  - (a) The distributable surplus is based on net income that includes realized gains on assets, but not unrealized gains. At least a specified portion of the distributable surplus (eg 90%) must be allocated to contract holders each year (or within a specified period, eg 8 years). In some cases, insurers have a practice of paying considerably more than the required minimum. Indeed, in some cases, the required minimum is 0%, but the insurer has a practice of paying a significant portion of the distributable surplus each year.
  - (b) The distributed surplus remains in a ring-fenced fund indefinitely until the insurer distributes it. At least a specified proportion (eg 90%) of any distribution must go to policyholders. The rest of the distribution

becomes available to the shareholders of the insurer. (Sometimes, if fund balances have grown over many years, there may be uncertainty about whether a portion that originated many years ago ‘belongs’ ultimately to contract holders or to shareholders. This is sometimes known as the ‘orphan estate’).

- (c) The insurer sets dividend scales periodically. These remain in force until changed and are designed in a way intended to distribute surplus to each generation of policyholders in an equitable manner that reflects that generation’s contribution to the surplus.
14. Unlike unit-linked (variable) contracts, a dpf gives the insurer some discretion over some or all of the following, but also places some constraints over that discretion:
- (a) timing of asset realisations
  - (b) the portion allocated to contract holders in aggregate (eg 90%, or some higher amount)
  - (c) how (and perhaps when) aggregate allocations to contract holders are shared between individual contract holders, and between different generations of contract holders.

**IFRS 4 requirements**

15. When the IASB developed IFRS 4, it excluded participating investment contracts from the scope of IAS 39 *Financial Instruments: Recognition and Measurement* (except the embedded derivative requirements) and from the classification requirements of IAS 32 *Financial Instruments: Presentation*, but not from the disclosure requirements of IAS 32 (except the fair value disclosure requirements). It did this because the dpf combines discretion and constraints on that discretion in a way that makes it difficult to determine whether, and to what extent, the dpf creates a liability.
16. The IASB knew this would be a difficult issue in phase II of its project on insurance contracts. To avoid prejudging the outcome of that discussion,

Paragraphs 34 and 35 of IFRS 4 provides the issuer of participating contracts with a choice: the issuer may classify the dpf as all equity, all liability, or part liability and part equity.

17. IFRS 4 also contains some requirements for a liability adequacy test for these contracts. Because those requirements will no longer be relevant when we complete this project, this paper does not discuss them.

## **Alternative approaches**

### ***Views 1 and 2***

18. In determining whether participating investment contracts should be retained within the scope of the future IFRS on insurance contracts or included in the scope of the FI standard, we considered the following views:
  - (a) **View 1** retain in the scope of the future insurance contracts standard and measure investment contracts with a dpf (as defined in IFRS 4) in the same way as participating insurance contracts (the FASB restricted the cash flows to those that are required by contract or by statute).
  - (b) **View 2** include in scope of the future FI standard and apply the FI requirements.

### ***Consequences of the different accounting approaches***

#### *Under future FI standard*

19. If the financial instruments model is applied to investment contracts with a dpf, this would involve the following steps:
  - (a) assess whether the dpf should be classified as entirely liability, entirely equity or partly equity and partly a liability and
  - (b) determine whether to measure the contract (or the part of the contract that is classified as a liability) at fair value through profit or loss or amortised cost [or fair value through OCI FASB only].

20. Amortised cost would include those embedded derivatives that are closely related to the host, measured on an expected value basis, discounted at the original effective interest rate. The boards have reached different tentative decisions:
- (a) IASB: bifurcate embedded derivatives that are not closely related to the host. The measurement will not reflect interdependencies (if any) between those embedded derivatives (if any) that are closely related to the host, those embedded derivatives (if any) that are not closely related to the host and the part (if any) of the dpf that is classified in equity.
  - (b) FASB: amortised cost not available if embedded derivatives would require bifurcation (eg if not clearly and closely related).
21. If fair value through profit or loss is used:
- (a) The surrender value floor may apply (ie the constraint that the fair value of the liability cannot be less than the amount payable on demand, discounted from the earliest date when the holder can demand payment).
  - (b) The measurement would reflect the risk of non-performance by the insurer. [IASB only: the effect of non-performance risk would go through OCI]
  - (c) [FASB only] Fair value through OCI: essentially combines fair value in the statement of comprehensive income with amortised cost in the income statement.
22. Acquisition costs:
- (a) Under existing IFRSs, in many cases much or all of the acquisition costs would be capitalised as the cost of a contractual right to benefit from providing investment management services.
  - (b) Under the revenue recognition proposals, acquisition costs for services (eg investment management) would not be capitalised and no revenue would be recognised at inception to offset the acquisition costs incurred.

- (c) [IASB only] If the contract is measured at amortised cost, the initial measurement would be fair value (generally deemed to equal the premium received at inception) less acquisition costs (which would often exceed the initial premium for regular premium contracts). If the contract holder can cancel the contract at a price that creates a loss for the issuer, the surrender option may need to be bifurcated. (Bifurcating the surrender option does not necessarily have the same result as applying a surrender value floor).
- (d) If the contract is measured at fair value, acquisition costs would be recognised as an expense.

*Under future insurance contracts standard*

23. If the proposed insurance contracts model is applied to these contracts, this would involve the following steps:
- (a) Determine whether the measurement of the liability should include all those cash flows that arise from the dpf:
    - (i) IASB: treat cash flows arising from the dpf in the same way as all other cash flows arising from the contract, ie include them in the measurement of the contract liability on an expected present value basis.
    - (ii) FASB: analyse cash flows arising from the dpf to determine whether they are required (eg by the contract or by a statute) or are discretionary. Include required cash flows in the measurement of the insurance liability. Recognise discretionary cash flows when the entity has an obligation to make payments. [The staff have not assessed whether this distinction would be consistent with what is required under current and proposed US GAAP for financial liabilities.]
  - (b) Measure the contract using the building block approach ie expected present value of cash flows plus [risk adjustment plus residual margin] or [composite margin]. If the contract includes a policyholder account balance, that component would be unbundled and accounted for under



the financial instruments guidance. Furthermore, under the proposed insurance contracts model, some embedded derivatives will be bifurcated.

- (c) The measurement would include the expected present value of all those cash flows that fall within the boundaries of the existing contract, defined as the point at which the insurer either is no longer required to provide coverage, or has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
- (d) The measurement would not reflect the risk of non-performance by the insurer.

24. Acquisition costs (other than investment management costs).

- (a) The IASB decided tentatively to exclude from the initial measurement of the residual margin an amount equal to the incremental acquisition costs.
- (b) The FASB decided tentatively that an insurer should expense all acquisition costs when incurred and not recognise any revenue (or income) to offset those costs incurred.

## **View 1**

### ***Supporting arguments***

25. Some believe that participating investment contracts should be scoped into the standard on insurance contracts, for the following reasons:

- (a) These contracts contain a complex package of interdependent options and guarantees (eg minimum guarantees, surrender options, conversion options, paid up options). If the measurement of the contract is at amortised cost, it is likely that some components will be required to be bifurcated [IASB]. Splitting these contracts into different components with different accounting treatments would not provide a faithful

representation of the package as a whole and would be burdensome and costly, resulting in information that is not understandable.

- (b) As already discussed by the boards in the context of participating insurance contracts, attempting to identify whether an investment contract with a dpf has both liability and equity components may be problematic, due to difficulties in identifying the **level of discretion** available to the insurer and thereby determining the actual amount of any **enforceable** obligation. The outcome of any such split may be arbitrary (because of the difficulty in identifying and separating the components) and, as a result, will be unlikely to result in decision – useful information.
- (c) The resulting measurements would be consistent with the measurements of participating insurance contracts, which often have many of the same characteristics.
- (d) Both types of participating contracts (investment and insurance) are sometimes linked to the same underlying pool of assets (and sometimes participating investment contracts share in the performance of insurance contracts). In those cases, applying different treatments to contracts that are linked to the same pool of assets would be confusing. Moreover, because some estimates of the cash flows to participating policyholders need to be made in aggregate across all participating contracts (both insurance and investment), rather than for individual contract types, it may be difficult to apply different accounting models to different parts of that aggregate participation.
- (e) Even though participating investment contracts do not satisfy the definition of an insurance contract, they typically have characteristics, such as long maturities, recurring premiums and high acquisition costs that are more commonly found in insurance contracts than in financial instruments. Some believe that the proposed model for insurance contracts provides a more faithful representation of these features than

the financial instruments model. For example, supporters of this view refer to the treatment of acquisition costs.

- (f) The measurement would exclude non-performance risk (under the IASB's exposure draft (ED) on fair value option, this component would be recognized in OCI).

***Defining the population***

- 26. The staff considered three approaches to defining the population of participating investment contracts to which the model developed for insurance contracts would apply under view 1; define the population as financial instruments:
  - (a) using the existing definition of a dpf in IFRS 4. The staff are not aware of any reason to make significant changes to this definition.
  - (b) that participate in the same pool of assets as insurance contracts.
  - (c) using the existing definition and requiring in addition that they participate in the same pool of assets as insurance contracts (ie combining conditions (a) and (b) above).
- 27. Those favouring view 1 recommend option (c) for the following reasons:
  - (a) Those who apply IFRSs are used to working with this definition and we are not aware of reasons to make significant changes.
  - (b) Using the existing definition also avoids the risk of unintended consequences.
  - (c) Option (c) scopes in only those investment contracts that 'share' in the performance of the same pool of assets as participating insurance contracts.
- 28. We believe that we can (and should) draft the accounting requirements for insurance contracts without using the term dpf. Thus, we would need to retain the term only if we need it to define a population of investment contracts to which we would apply the model being developed for insurance contracts.

**Contract boundary**

29. View 1 gives rise to one other issue. The model being developed for insurance contracts defines the contract boundary as the point at which the insurer either is no longer required to provide coverage, or has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
30. Because that definition relies on the existence of insurance risk, it would not be relevant for investment contracts with a dpf because, by definition, such contracts do not transfer significant insurance risk. The obvious solution is to replace the reference to risk with a reference to the dpf. Therefore, the staff recommend the following definition of the contract boundary, if the boards adopt view 1.

The boundary of an investment contract containing a dpf is the point at which the contract holder no longer has a contractual right to receive benefits arising from the dpf.

**View 2**

31. Others support view 2, for the following reasons:
- (a) Participating investment contracts should be treated like any other financial instrument because they do not transfer significant insurance risk to the insurer.
  - (b) Applying the insurance model to contracts that do not meet the definition of an insurance contract would cause additional complexities, for example the need to ring fence those contracts from other investment contracts and develop a separate contract boundary principle.
  - (c) In some jurisdictions, investment contract with dpf form a substantial part of an insurer's business. Sometimes, the size of those portfolios is similar to the size of the portfolios of insurance contracts. Bringing investment contracts with dpf into the scope of the insurance contracts

standard would significantly expand the number contracts that are accounted for under that standard; but that scope expansion relate to contracts that are not insurance contracts. Furthermore, because investment contracts with dpf are often issued by insurers, the insurance standard may appear to take on the character of an industry-specific standard.

- (d) Separating a contract with dpf into a component that contains obligations and a component that does not contain an obligation is compatible with the definition of a liability that is provided by the IASB *Framework* and the FASB *Concepts Statements*, and is useful in highlighting (in equity) any loss absorption capacity provided by the dpf.

### Staff recommendations

32. In addition to the reasons put forward by staff in support of views 1 and 2, we have considered the boards' respective tentative decisions on financial instruments (summarized in paragraphs 19-22). The main drivers in our recommendations are:

- (a) The fact that these contracts are not insurance contracts, because they do not transfer significant insurance risk. [This is an issue for both boards.]
- (b) Practical problems that would arise in applying one approach to participating insurance contracts and another to participating investment contracts that participate in the same pool of assets. [Given the boards' other decisions, the IASB may be more likely to see this as an issue and the FASB may be less likely to see this as an issue.]
- (c) Difficulties in determining whether an obligation exists in respect of all expected future dividends arising from the existing contracts. [Given the boards' other decisions, the IASB is likely to see this as an issue but the FASB presumably does not.]

- (d) Practical problems in determining the fair value of a participating insurance contract if the conclusion is reached that no present obligation exists for some or all expected future dividends arising from the existing contracts. For example, what assumption should be made about lapse rates? [This could be an issue for both boards.]
  - (e) Practical problems that may arise if it is necessary to bifurcate some but not all embedded derivatives in a contract. [Given the boards' other decisions, the IASB is likely to see this as an issue but the FASB may not.]
33. In addition, we draw attention to one practical consequence of the decision the boards will make. Significant acquisition costs arise for many of these contracts. Both boards would recognise those costs as an immediate expense, but they may have different views on whether the issuer should recognise at inception the amount of revenue needed to recover those costs:
- (a) To recognise such revenue at inception would be consistent with the IASB's decisions in this project and with the IASB's existing and proposed approach for financial liabilities carried at amortised cost. However, it would be inconsistent with the IASB's decisions on revenue recognition and its existing and proposed treatment of financial liabilities carried at fair value.
  - (b) To recognise **no** such revenue at inception would be consistent with the FASB's decisions in this project and on revenue recognition and financial instruments.
34. We believe the balance of arguments may be different for the two boards, given the different tentative decisions they have made on participating insurance contracts. Therefore, we recommend that:
- (a) The IASB adopts view 1, ie includes participating investment contracts in the scope of the future insurance contracts standard.
  - (b) The FASB adopts view 2, ie includes participating investment contracts in the scope of the future FI standard.

35. Staff also recommend that we explain the boards' tentative decisions in the Basis for Conclusions in the forthcoming ED and ask a question on this topic. We acknowledge that the accounting treatment of participating investment contracts is an important issue for some countries and we expect to consider this in round two of the field testing, to be carried out during the comment period.

**Questions for the boards**

1. Which view do you support:

- (a) include in the scope of insurance contracts standard (view 1); or
- (b) include in the scope of a future standard on financial instruments (view 2)?

2. If you adopt view 1:

- (a) should view 1 apply to investment contracts that contain a dpf, (as defined in IFRS 4 *Insurance Contracts*) and that participate in the same pool of assets as participating insurance contracts?
- (b) should the contract boundary for these contracts be defined as the point at which the contract holder no longer has a contractual right to receive benefits arising from a discretionary participation feature?

## Appendix A Extracts from IFRS 4 *Insurance Contracts*

### Appendix

#### Extracts from IFRS 4 *Insurance Contracts*

<b>discretionary participation feature</b>	<p>A contractual right to receive, as a supplement to <b>guaranteed benefits</b>, additional benefits:</p> <ul style="list-style-type: none"><li>(a) that are likely to be a significant portion of the total contractual benefits;</li><li>(b) whose amount or timing is contractually at the discretion of the issuer; and</li><li>(c) that are contractually based on:<ul style="list-style-type: none"><li>(i) the performance of a specified pool of contracts or a specified type of contract;</li><li>(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or</li><li>(iii) the profit or loss of the company, fund or other entity that issues the contract.</li></ul></li></ul>
<b>Guaranteed benefits</b>	<p>Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.</p>
<b>guaranteed element</b>	<p>An obligation to pay <b>guaranteed benefits</b>, included in a contract that contains a discretionary participation feature.</p>

#### *Discretionary participation features in insurance contracts*

- 34 Some insurance contracts contain a discretionary participation feature as well as a *guaranteed element*. The issuer of such a contract:
- (a) may, but need not, recognise the guaranteed element separately from the discretionary participation feature. If the issuer does not recognise them separately, it shall classify the whole contract as a liability. If the issuer classifies them separately, it shall classify the guaranteed element as a liability.
  - (b) shall, if it recognises the discretionary participation feature separately from the guaranteed element, classify that feature as either a liability or a separate component of equity. This IFRS does not specify how the issuer determines whether that feature is a liability or equity. The issuer may split that feature into liability and equity components and shall use a consistent accounting policy for that split. The issuer shall not classify that feature as an intermediate category that is neither liability nor equity.
  - (c) may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability shall be recognised in profit or loss. If part or all of the discretionary participation feature is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to minority interests). The issuer shall recognise the portion of profit or loss attributable to any equity component of a discretionary participation feature as an allocation of profit or loss, not as expense or income (see IAS 1 *Presentation of Financial Statements*).



- (d) shall, if the contract contains an embedded derivative within the scope of IAS 39, apply IAS 39 to that embedded derivative.
- (e) shall, in all respects not described in paragraphs 14-20 and 34(a)(d), continue its existing accounting policies for such contracts, unless it changes those accounting policies in a way that complies with paragraphs 21-30.

*Discretionary participation features in financial instruments*

35 The requirements in paragraph 34 also apply to a financial instrument that contains a discretionary participation feature. In addition:

[Paragraph 35(a) and (b) not reproduced. They refer to a liability adequacy test that would no longer be relevant.]

- (c) although these contracts are financial instruments, the issuer may continue to recognise the premiums for those contracts as revenue and recognise as an expense the resulting increase in the carrying amount of the liability.

**Extract from Basis for Conclusions  
Discretionary participation features**

BC154 Some insurance contracts contain a discretionary participation feature as well as a guaranteed element. The insurer has discretion over the amount and/or timing of distributions to policyholders, although that discretion may be subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. Distributions are typically made to policyholders whose contracts are still in force when the distribution is made. Thus, in many cases, a change in the timing of a distribution means that a different generation of policyholders will benefit.

BC155 Although the issuer has contractual discretion over distributions, it is usually likely that current or future policyholders will ultimately receive some part of the accumulated surplus available, at the reporting date, for distribution to holders of contracts with discretionary participation features (ie distributable surplus). The main accounting question is whether that part of the distributable surplus is a liability or a component of equity. The Board will explore that question in phase II.

BC156 Features of this kind are found not only in insurance contracts but also in some investment contracts (ie financial liabilities). Requiring a particular accounting treatment in phase I for investment contracts with these features would create the risk that the Board might decide on a different treatment in phase II. Furthermore, in some cases, holders of insurance contracts and investment contracts have a contractual right to share in discretionary payments out of the same pool of assets. If the Board required a particular treatment for the discretionary participation features of the investment contracts in phase I, it might prejudice the treatment of these features in insurance contracts that are linked to the same pool of assets.

BC157 For these reasons, the Board decided not to address most aspects of the accounting treatment of such features in phase I, in either insurance contracts or investment contracts. However, paragraphs 34 and 35 of the IFRS confirm that it is unacceptable to classify a discretionary participation feature as an intermediate category that is neither liability nor equity, because this would be inconsistent with the *Framework*. If a balance sheet item does not meet the *Framework*'s definition of, and recognition criteria for, assets or liabilities, that item is included in equity.

BC158-BC159 not reproduced. They relate to a liability adequacy test that will no longer be relevant.

BC160 There may be timing differences between accumulated profits under IFRSs and distributable surplus (ie the accumulated amount that is contractually eligible for distribution to holders of discretionary participation features). For example, distributable surplus may exclude unrealised investment gains that are recognised under IFRSs. The resulting timing differences are analogous, in some respects, to temporary differences between the carrying amounts of assets and liabilities and their tax bases. The IFRS does not address the classification of these timing differences because the Board will not determine until phase II whether the distributable surplus is all equity, all liability or part equity and part liability.

BC161 The factor that makes it difficult to determine the appropriate accounting for these features is constrained discretion, in other words, the combination of discretion and constraints on that discretion. If participation features lack discretion, they are embedded derivatives and within the scope of IAS 39.

BC162 The definition of a discretionary participation feature does not capture an unconstrained contractual discretion to set a 'crediting rate' that is used to credit interest or other returns to policyholders (as found in the contracts described in some countries as 'universal life' contracts). Some view these features as similar to discretionary participation features because crediting rates are constrained by market forces and the insurer's resources. The Board will revisit the treatment of these features in phase II.

BC163 Some respondents asked the Board to clarify the treatment of premiums received for financial instruments containing discretionary participation features. Conceptually the premium for the guaranteed element is not revenue, but the treatment of the premium for the discretionary participation feature could depend on matters that will not be resolved until phase II. Furthermore, requiring the premium to be split could involve system changes that might become redundant in phase II. To avoid unnecessary disruption in phase I, the Board decided that entities could continue presenting premiums as revenue, with a corresponding expense representing the change in the liability.

BC164 Conceptually, if part or all of a discretionary participation feature is classified as a component of equity, the related portion of the premium should not be included in profit or loss. However, the Board concluded that requiring each incoming premium to be split would require systems changes beyond the scope of phase I. Therefore, the Board decided that an issuer could recognise the

entire premium as revenue without separating the portion that relates to the equity component. However, the Board confirmed that the portion of profit or loss attributable to the equity component is presented as an allocation of profit or loss (in a manner similar to the presentation of minority interests), not as expense or income.

BC165 Some suggested that investment contracts containing a discretionary participation feature should be excluded from the fair value disclosure required by IAS 32. They noted both conceptual and practical problems in determining the fair value of an instrument of this kind. However, instead of creating a new exclusion from the required disclosure of fair value, the Board added new paragraph 91A to IAS 32. This extends existing requirements in IAS 32 governing those unquoted equity instruments whose fair value cannot be determined reliably.