IFRS

Insurance Working Group Meeting
16 May 2011

Agenda reference **7**

Staff Paper

Topic **Measurement of Policyholder Participation**

What is this paper about and what did the staff recommend?

1. This paper considers how to measure contractual participation features. The issue addressed in this paper is also described in agenda paper 7A.

2. The staff will recommend in the 11 May 2011 joint board meeting that:

   (a) the fulfilment cash flows should include the cash flows expected to result from the policyholder participation on the same basis as the measurement of the underlying items the policyholder participates in. This could be assets and liabilities, the performance of underlying pool of insurance contracts or the performance of the entity.

   (b) the measurement of the participating contract should reflect the asymmetric risk sharing between insurer and policyholder in the contractually linked items that exists because of the minimum guarantee.

   (c) the presentation of the changes in the (participating) insurance contract liability in the statement of comprehensive income should be consistent with the presentation of the changes in the linked items (ie profit or loss, or in other comprehensive income)

   (d) the same measurement approach should apply to unit-linked and participating contracts. Consequently the boards should not proceed with the proposals in the IASB's exposure draft (ED) for consequential amendments relating to the following items held in unit-linked funds: treasury shares and owner occupied property.

Staff analysis and recommendation

Potential accounting mismatches

3. Under the proposals in the ED, cash flows from participation features are treated in the same way as any other cash flow in the measurement model. Depending on the nature of the participation feature, the insurer needs to determine the expected present value of the cash flows that will flow through to participating policyholders as a result of current and future statutory results.

4. There is a potential for accounting mismatches when the measurement of the participating insurance contract liability is not consistent with the measurement of assets and liabilities used as the basis for determining the participation, ie if any asset or liability that is contractually linked to the policyholder cash flows is not measured at fair value. The following simplified example illustrates the issue:

> Assume there is an asset with a fair value of CU1,200. IFRS/US GAAP book value is CU1,000. The policyholder participates with 90% of the performance of this asset above CU1,000.
>
> The insurance contract liability would be CU1,185 for this with the following components:
>
> - 1,000 guaranteed amount
> - 90% of the 200 (Fair Value above book, ie 1,200 – 1,000)
> - 5 (in this example assumed to be the fair value of the asymmetric risk sharing between policyholder and shareholder)
>
> In this case, there is an accounting mismatch of 180 for the difference between policyholder share of the book value of the assets and the present value of the expected cash flows of the insurance contract liability. That accounting mismatch would not arise if the insurer measured the asset at fair value.

5. The mismatches can be more or less pronounced depending on the jurisdiction and depending on which assets/liabilities are subject to the contractual linkage.

Staff recommendation

6. The staff will recommend that the boards modify the measurement of the participation features within the insurance contract liability as proposed in the ED, for the following reasons:

   (a) The more relevant economic phenomenon is the contractual linkage between the assets/liabilities and the insurance contracts liability. The staff sees more benefit in trying to depict this phenomenon than to model the ultimate cash outflows and thereby create accounting mismatches.

   (b) The relationship between the performance of the assets/pool of contracts/entity and the insurance contracts liability can be more easily explained to users.

7. We discuss this in the following paragraphs.

Eliminating the mismatch by requiring insurers to apply the fair value option

8. Some would argue that an insurer could eliminate some of the accounting mismatches by choosing the fair value option where possible. However, the staff is not convinced that this would appropriately reflect the contractual linkage, because:

   (a) This would leave significant accounting mismatches for participation features for which there are no fair value options, for example for deferred tax assets, property, plant and equipment and other liabilities. As some participation features refer to the entire (statutory) surplus of the insurer in fulfilling the contract, this would in consequence leave any item on the balance sheet that is not fair valued exposed to an accounting mismatch.

   (b) In addition, there are items, where even a measurement at fair value does not prevent an accounting mismatch. For example, assume the policyholders participate in all costs of an entity. The entity purchases a new computer system where the costs are not included in the measurement of the insurance contract liability (because they are not direct). Under the ED proposal for the accounting for participation features this would effectively result in an immediate recognition of a gain because the participation feature would be reflected directly in profit or loss as a reduction of future cash flows to the policyholders, whereas the asset is recognised with no income effect.

(c) Some would argue that the other accounting standards provide different measurement attributes for good reasons and the fair value option should only be seen as an exit for unavoidable mismatches.

(d) In many cases, the participation feature is based on a measurement that is closer to the IFRS/US GAAP book values (eg amortised cost for financial assets is closer than fair value to the participation system in many countries). In such cases, trying to measure the participation cash outflows on a current (ie fair value) basis and remedy the accounting mismatch with the fair value option appears counterintuitive in relation to the nature of the participation feature and to introduce artificial complexity.

9. Therefore, we propose this treatment even in situations where the fair value option is available to eliminate an accounting mismatch.

What would the liability represent under the staff recommendation?

10. The insurance contract liability under the staff recommendation would show the current liability to the policyholders under the participation feature based on the performance of the linked item as reported in the IFRS or US GAAP financial statements, reflecting the fact that the cash generated by the linked items determines the cash in which the policyholders will participate.

Asymmetric risk sharing

11. As described in the example in paragraph 4, the asymmetric risk sharing and the guarantees to policyholders are important phenomena that need to be reflected in

the measurement of the insurance contract liability. This also means that the current intrinsic value and time value of the options and the guarantees need to be reflected in the measurement of the insurance contract.

The use of other comprehensive income

12. Some of the performance of the contractually linked assets and liabilities may be reported in other comprehensive income (OCI). In the staff's view, an accounting mismatch would arise if the measurement of the participation feature in the liability did not follow that linkage. Consequently, the staff proposed that the measurement of the linked participation feature should also be reflected in OCI to the extent that it results from participation in items of OCI. If these other standards require recycling of some amounts, the participation feature measurement would follow this treatment.

Unit-linked contracts

13. In the staff's view, the approach proposed in this paper would apply equally to unit-linked contracts. Thus, there would be no need to treat unit-linked contracts as a separate case, as proposed in the ED. Furthermore, there would be no need to expand the proposed fair value options for treasury shares and owner-occupied property. This would be result in consistent treatment for all types of policyholder participation.

Questions to the working group
1) What are your views on the staff recommendation for the measurement of participation features? Do you have feedback on the expected impact? 2) Do you agree with the staff's view on treating a unit-linked contract as a 100% participating contract?

Implications for other parts of the project

Unbundling of unit-linked contracts

14. For some unit-linked contracts the decision on unbundling could have the result that the unit-linking feature is unbundled and these contracts would be largely within the scope of the financial instruments standards. The staff will revisit the measurement decisions on unit-linked contracts after the boards' decision on unbundling.

Presentation of contracts with policyholder participation and unit linked contracts

15. The staff will consider the nature of both types of contracts in developing the presentation model.

Appendix A: Examples of accounting mismatches in the ED and the effect of the staff recommendation

A1. Some participation features are linked to the surplus of an entity. To the extent that the surplus reflects the measurement of items not at fair value, an accounting mismatch can occur. The following list indicates some assets and liabilities that may determine the measurement of participation features:

(a) Financial Instruments at **amortised cost** (IFRS 9 *Financial Instruments/* ASC 320-10). Tentative FASB decisions in the *Accounting for Financial Instruments* project also contain amortized cost provisions for some instruments.

(b) **Equity instruments at Fair Value with changes through OCI** (IFRS 9)

(c) **Debt instrument at Fair Value with changes through OCI (ASC 320-10).** Tentative FASB decisions in the *Accounting for Financial Instruments* project also contain FV-OCI provisions for some debt instruments.

(d) **Fair value option for a financial liability** (IFRS 9/ASC 825)

(e) **Taxes** (IAS 12 Income Taxes/ ASC topic 740 Income Taxes) are measured on an undiscounted basis.

(f) **Other liabilities** (for example an environmental contingency) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*/ASC topic 410-30 Environmental obligations. The measurement is based on an expected present value, but the recognition criteria can be different.

(g) **Investment property** (IAS 40 *Investment Property*/ there is no equivalent standard under US GAAP) uses alternative models: cost model and fair value model. The FASB is scheduled to deliberate the treatment of investment property held by qualifying entities in the near future.

(h) **Owner occupied property** (IAS 16 *Property, Plant and Equipment*/ ASC topic 970-360 Real Estate) uses alternative models: cost model and revaluation model.

(i) **Treasury shares** and **own debt instruments**. These are not considered as assets and consequently not recognised under IAS 32. (IAS 32/ASC 505 and ASC 470)

(j) **Investments in associates** (IAS 28 *Investments in Associates* / ASC topic 323 Investments-Equity Method and Joint Ventures). The measurement is based on the equity method, but for unit-linked contracts, the fair value option could be selected.

(k) Other activities accounted for in **standards that do not use a current** measurement (eg leases) and future standard developments (eg leases) that could create additional accounting mismatches

(l) **Expenses** that are included in the participation feature. For example, if the entity decides to purchase a new claims administration system (and the policyholders are participating in the expense), the expected present values includes the policyholder participation in all expenses until the system is amortised, while the cost are amortised over the time horizon.

A2. Under investment company guidance in ASC 946 the mismatches described above do not exist since an entity measures their assets and liabilities at fair value. Most separate accounts in the US are accounted for using the investment company guidance.