# STAFF PAPER

**14 November – 18 November 2011**

FASB | IASB Meeting

This paper will also be discussed at the FASB Education Session on 09 November 2011.

| **Project** | **Insurance Contracts** | | |
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| Paper topic | Disaggregation of Explicit Account Balances | | |



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This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB *Action Alert* or in IASB *Update*.

## What is the purpose of this paper?

1. The purpose of this paper is to determine how to account for and present:
   a. explicit account balances in the statement of financial position
   b. related income and expenses in the statement of comprehensive income
2. This paper does not address:
   a. Presentation in the statement of financial position of assets that are legally segregated from the assets of an insurer but by which the performance directly impacts an explicit account balance. This topic will be covered at a future meeting.
   b. The boards have previously tentatively decided that an insurer should unbundle embedded derivatives and goods/services that meet specified criteria from an insurance contract. This paper does not revisit those decisions.

## Summary of Staff Recommendation

3. The staff recommend the following:
   a. A contract has an explicit account balance if both of the following conditions are present:

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The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

i. The balance is an accumulation of the monetary amount of transactions between the policyholder and the insurer.

ii. The balance is credited with an explicit return. A return is explicit if it is determined by applying either of the following to the balance:

(1) a contractual formula in which the insurer may have the ability to reset the return rate during the life of the contract

(2) an allocation determined directly by the performance of specified assets

b. An insurer shall measure explicit account balances and services associated with explicit account balances (eg asset management services), if any, together with the other components in the insurance contracts. The insurer shall present the explicit account balances separately from the insurance contracts liability on the face of the statement of financial position (rather than in the notes to the financial statements) at an amount equal to the sum of:

i. the explicit account balance, and

ii. an accrual for all fees and returns through the reporting date.

The measurement of the explicit account balance should not include expected future cash inflows or outflows, whether contractual or based on policyholder behavior (eg surrender charges).

c. Premiums accumulated in the explicit account balance and claims paid or withdrawals from the explicit account balance shall not be recognised in the statement of comprehensive income.

d. The following (including any related accruals) shall be recognised in the statement of comprehensive income:

i. any fees deducted from the explicit account balance

ii. investment returns on an insurer's assets regardless of whether or not the explicit account balance is linked to those assets

iii. interest credited to the explicit account balance

### Structure of this Paper

4. This remainder of this paper is structured as follows:

   a. Background information

   b. Staff analysis

      i. Should some components of the insurance liability be presented separately?

      ii. Definition of 'explicit account balance'

      iii. Results of applying the tentative unbundling criteria

      iv. Should explicit account balances be recorded in an insurer's financial statements and if so, should they be offset?

      v. If the explicit account balances and the related assets are recorded in an insurer's financial statements, how should they be measured and presented?

         (a) Measure and present explicit account balances in the same way as financial instruments (ie unbundle such balances to another standard).

         (b) Measure explicit account balances consistently with the insurance liability but present separately (ie disaggregate such balances).

            (i) Other practical considerations about this alternative

   c. Staff recommendation

   d. Presentation in the income statement of changes in explicit account balances

   e. Appendix A- Typical Lifecycle of a Long-Duration Contract from Inception

f. Appendix B- Account Balances and Related Assets as Assets/Liabilities of the Insurer (based on criteria from Conceptual Framework)

g. Appendix C- Analysis of Tentative Unbundling Criteria Applied to Common Contracts

## Background Information

### *Proposals in the exposure draft and discussion paper*

5. In the IASB exposure draft *Insurance Contracts* (the "ED") and the FASB discussion paper *Preliminary Views on Insurance Contracts* (the "DP"), the boards proposed that some components of insurance contracts should be unbundled from the insurance component of those contracts. Unbundled components would be accounted for using the guidance that would apply to that component if it were a stand-alone contract (eg an embedded derivative should be unbundled from an insurance contract and measured at fair value in the same way as other derivatives).

### *Previous Board Discussions*

6. At the 04 May 2011 joint board meeting, the boards tentatively decided to pursue an approach to unbundling explicit account balances and goods/services that would rely on the criteria for separating performance obligations in the revenue recognition project. However, some board members indicated that their decision was conditional upon seeing the proposed wording of the separation criteria and an illustration showing what types of contracts would be separated.

7. At the 13 June 2011 joint board meeting, the boards tentatively decided to pursue a presentation model for insurance contracts that would display volume information (ie premiums, benefit payments, etc…) in the statement of comprehensive income. In arriving at their tentative decision, some board members raised concerns about whether volume information relating to explicit

account balances should be included (or separated from other activities either by unbundling or by another method) since, in their opinion, the cash flows into and out of such account balances are unrelated to an insurer's underwriting operations.

***Feedback from Constituents***

8. Feedback from constituents primarily indicates that the methodology put forth in the ED and DP was unclear and that it would be very difficult to apply. Furthermore, a number of constituents commented that it is unclear how presentation would be affected by a decision of whether or not to unbundle.

9. Some respondents to the ED and the DP believe that separating investment components from insurance components enhances a user's ability to compare the insurer's risk profile with the risk profile of other insurers and non-insurers. For example, some argue that separation (ie by unbundling or some other means) would more faithfully represent the different risks that arise when a bank issues some unit-linked contracts with insurance coverage and others without insurance coverage than if that bank were to account for all contracts with insurance coverage using the building block approach.

10. Regarding investment components specifically, several respondents indicate a preference to unbundle so that the investment components can be measured using the same measurement attribute as the assets backing the insurance liability (ie at amortized cost or fair value). These respondents propose this as a means of allowing entities to select cost-based measures for particular assets (when so permitted by IFRS and U.S. GAAP) without triggering a mismatch with the insurance liability.

11. Still others (mostly respondents from Australia) support the proposal to unbundle the specified account balances because it would allow for a continuation of current unbundling practices that they believe work well.

12. Practically, most respondents support separating investment components from insurance components but doubt that it can be done in a manner where the benefits

outweigh the costs. These respondents believe that it would not be useful and/or representationally faithful to recognize inflows and outflows to a deposit-type account as revenues and expenses of an insurer. Some respondents suggest that legally separated assets and the related liabilities should be presented separately and the related activity in the statement of comprehensive income should be presented on a net basis.

13. Other respondents to the ED and the DP believe that unbundling is unnecessary for investment components. They argue that that the costs of unbundling outweigh the benefits because the measurement of the unbundled component would be similar if it were to be measured at fair value.

14. Other respondents question the incremental value of the information that would result from unbundling only specified insurance contracts because, according to these respondents, an investment component is arguably a feature of most long-term insurance contracts. Consequently, unbundled insurance contracts would not be comparable to bundled insurance contracts.

15. Many respondents believe that unbundling would be costly for them because they do not manage or report on the different components separately for regulatory or financial reporting purposes. If unbundling were required, these insurers would need to:

    a. review the structure of their existing contracts to determine whether investment components should be unbundled, and

    b. design or modify their IT systems so that the individual components could be tracked and reported on separately, and

    c. develop a methodology for estimating what portion of each cash flow relates to what component for purposes of allocation.

    Some of these respondents indicated that in their opinion, the costs of unbundling as it was presented in the ED would outweigh the benefits, but that they believe the information would be useful if it were able to be provided in a more efficient manner.

***Current Guidance under U.S. GAAP and IFRS***

16. Both Topic 944 (formerly SFAS 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*) and IFRS 4, *Insurance Contracts* require separate presentation and measurement of an investment component within an insurance contract in specified circumstances. SFAS 97 addresses insurance contracts that have characteristics of universal life-type contracts[1] or investment contracts[2]. IFRS 4 requires unbundling if:

    a. the insurer can measure the investment component[3] (including any embedded surrender options) separately (ie without considering the insurance component), and

    b. the insurer's accounting policies do not otherwise require it to recognize all obligations and rights arising from the deposit component.

17. Under IFRS 4, unbundling is permitted if the insurer can measure the deposit component separately but its accounting policies require it to recognize all obligations and rights arising from the deposit component. Conversely, unbundling is prohibited if an insurer cannot measure the deposit component separately.

18. If unbundled, a stand-alone obligation to settle a deposit-type account balance would be considered a financial liability within the scope of IAS 39, *Financial*

[1] SFAS 97 defines a universal life-type contract as one that provide either death or annuity benefits and are characterized by any one of the following features: (a) one or more of the amounts assessed by the insurer against the policyholder—including amounts assessed for mortality coverage, contract administration, initiation, or surrender are not fixed and guaranteed by the terms of the contract, (b) amounts that accrue to the benefit of the policyholder including interest accrued to policyholder balances—are not fixed and guaranteed by the terms of the contract, or (c) premiums may be varied by the policyholder within contract limits and without consent of the insurer.

[2] Investment contracts issued by an insurance enterprise, as defined in SFAS 97, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

[3] A contractual component that is not accounted for as a derivative under IAS 39 and would be within the scope of IAS 39 if it were a separate instrument.

*Instruments: Recognition and Measurement,* and Topic 820, *Fair Value Measurement,* because it is a contractual obligation 'to deliver cash to another [second] entity'. The deposit component reflects a contractual obligation for an insurer to pay the value of the account balance to the policyholder on death or surrender.

19. US GAAP similarly would require deposit-type account balances to be recorded as liabilities of the insurer. SFAS 97 was issued in order to address in part insurance contracts with account balances, which had grown increasingly popular in the U.S. in the years leading up to the issuance of that guidance. The introduction to SFAS 97 reads as follows:

    "This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder."

20. If the liability is directly linked to an asset portfolio that is legally segregated (eg separate accounts), current US GAAP guidance requires an insurer to measure and present a deposit-type account balance as a liability separately from the insurance contract. The amount of the account balance (ie the liability) and the assets backing the liability are reflected at identical amounts in the balance sheet. Where the value of the assets is regularly remeasured to fair value (ie as it is for variable and/or most unit-linked accounts), the account balance is remeasured as well.

## Staff Analysis

***Should some components of the insurance contract liability be presented separately?***

21. Although some constituents argue for very little unbundling, most argue and the staff agrees that failing to delineate between an insurer's general liabilities (ie those that have a mortality and morbidity element and for which the insurer

accepts the risk) and those that are account balances (ie there is a deposit element which under all circumstances the policyholder will receive benefits from) could be misleading to users and could complicate users analysis of the insurer's results. Many people believe that account balances are akin to demand deposits or mutual funds which have distinctly different characteristics than an insurance contract liability, and that it is critical that users be able to distinguish the results of an insurer's underwriting and investing activities from inflows/outflows to or from a policyholder's account balance.

22. As such, the staff recommended at the 04 May 2011 joint board meeting that specified components should be separated (unbundled) from the insurance contract liability and the boards tentatively agreed. The boards' tentative decision indicated that a component should be separated if such component is an explicit account balance that meets the criteria for separating performance obligations in the revenue recognition project. However, the boards asked the staff to:

    a. re-examine the definition of an explicit account balance and clarify the criteria for when an account balance should be deemed explicit

    b. analyze what types of contracts would typically be unbundled based on applying the tentative decisions for separating performance obligations in the revenue recognition project

***Definition of explicit account balances***

23. At the 04 May 2011 joint board meeting, the staff proposed to define explicit account balance as follows in agenda paper 1E/66E:

    *'Explicit account balances are regularly communicated to the policyholder. For explicit account balances, the insurer credits an explicit return based on the value of the account balance. The insurer may have the ability to vary the fees and assessments that are charged. The policyholder may have [the ability] to withdraw cash and pay for insurance coverage, depending on the contract terms.'*

24. In order to clarify the definition and identify criteria that can be used to determine when an account balance should be deemed 'explicit' the staff analyzed several common contracts that contain account balances.

*Traditional life insurance contract with a cash surrender value*

25. Most jurisdictions, by law, require life insurance contracts and annuities to have a cash surrender value ("CSV") where policyholders accumulate an account balance that they would receive if they surrender their policy prior to death. Policyholders also may borrow money against the CSV in the form of a policy loan; any outstanding policy loan balance and unpaid interest is deducted from the benefit received upon death and if greater than the CSV may cause the policy to lapse (terminate).

26. The CSV generally takes into consideration the expected cash receipts (premium), interest crediting rates, and recoupment of expenses for maintenance of the policy and acquisition costs (including commissions, premium taxes, underwriting, etc.). The CSV is minimal in the early years of a contract but increases over time as upfront costs are recouped through the receipt of premium payments. Appendix A is a basic illustration that shows the life cycle of a contract, specifically:

    a. The CSV surpasses the cumulative premium paid only after the policy has been in force for 14 years.

    b. The CSV surpasses the death benefit after the policy has been in force for 78 years.

27. As illustrated in the example, the CSV is an account balance that is contractually payable on demand and is calculated and tracked by insurance companies. Therefore, some believe that the balance should be disaggregated from the insurance liability.

28. However, others argue that there is no benefit to disaggregating the cash surrender balance in the financial statements. In determining the CSV on individual contracts, the insurer assumes the policyholder will not cancel their policy prior to the insured event occurring (ie death of the policyholder) and the insurance

liability increases over time. Using the example in appendix A and assuming the policyholder is 65 (year 30 of the contract), what is the value in showing the CSV of CU 152,241 separate from the remaining liability of CU 91,290 which would need to be adjusted at the portfolio level? In the following year, the death benefit increases by CU 6,914 however the CSV increases by CU 9,821 while the remaining insurance liability increases by only CU 2,955. The staff believe that separating the change in the liability would not provide decision useful information for users and could be misleading.

29. The staff also considered the impact that disaggregation of the CSV would have on the statement of comprehensive income. One of the items under consideration in this paper is whether the statement of comprehensive income should exclude premiums deposited and amounts of withdrawals from the explicit account balance thus only reflecting the underwriting and investing results of the insurer. Using the example in appendix A, the insurer would recognize premiums in the early years of the contract but then minimal or no premiums in subsequent years. The staff believe that this pattern of recognition would not properly reflect the economics of the contract. In order to properly adjust the pattern of income recognition, insurers would have to split the premiums and investment income between the CSV and the insurance liability at each reporting date in a manner that most would consider to be arbitrary.

30. Based on this analysis, the staff believe that the CSV within an insurance contract should not be disaggregated from the insurance liability. The staff believe that the CSV is more of an implicit (ie derived) account balance as opposed to an accumulation of transactions between the policyholder and the insurer.

31. Some have questioned whether there should be a deposit floor for the measurement of the insurance contract liability, which may be the CSV for some contracts, given that this represents the amount payable to a policyholder on demand. In January 2010, the FASB voted and the IASB reaffirmed their decision against a requirement to consider a deposit floor in the insurance contracts project. 'Deposit floor' is a term often used to describe the provision in IAS 39 that states the fair

value of a financial liability with a demand feature (eg a demand deposit) cannot be less than the amount payable on demand discounted from the first date that the amount could be required to be paid. The staff do not intend to revisit this position.

*Non-traditional life insurance contracts with policyholder account balances*

32. These types of contracts provide for a policyholder account balance, to which cash inflows and outflows are credited as they are received or disbursed. Typical such contracts include universal life, variable universal life, annuities and unit-linked insurance contracts. When an insurer refers to an account balance within a non-traditional contract, the balance is understood to be the result of the inflows and outflows to the account balance (ie the accumulation of transactions between the policyholder and the insurer). Typically, such account balances are credited with some sort of return by the insurer, whether the return is a result of (a) changes in the value of underlying assets such as publicly traded investment funds (b) allocations made by the insurer that are based on an explicit rate applied to the account balance and determined by a contractual formula or (c) allocations made by the insurer that reflect the performance of some underlying asset, whether that asset is specific to the contract or is a part of the insurer's general investment account.

33. The calculation of the CSV in a traditional life contract is very different than the calculation of an explicit account balance for non-traditional life insurance contracts. Under non-traditional life contracts, the account value that can be withdrawn by the policyholder is increased by the amount of premiums paid and investment income or interest credited and fees are withdrawn over time. The account balance is generally greater than the additional benefit that would be paid upon death which is typically minimal unless there are guarantees. The charge for surrendering a non-traditional life insurance contact early is an explicit charge against the account value, whereas for traditional life insurance contracts surrender charges are implicitly communicated as a reduction of the CSV.

***Identifying explicit account balances***

34. Based on the analysis of traditional life insurance contracts with CSVs and non-traditional life insurance contracts with policyholder account balances, the staff believe that the most important criteria in determining whether an account balance is explicit are:

    a. The value of an account balance should be an accumulation of transactions between the policyholder and the insurer:

        i. the amount of receipts from the policyholder and the amount of any interest or investment income credited to the account balance, and

        ii. the aggregate amount of any payments to the policyholder and any charges assessed to the account balance by the insurer (eg mortality and expense fees, cost of insurance charges, etc...)

    b. Any return credited to an explicit account balance must also be explicit. The boards did not disagree with the inclusion of this criterion in the definition at the 04 May 2011 joint board meeting. An return is explicit if it is determined by applying either of the following to the account balance:

        i. a contractual formula in which the insurer may have the ability to reset the return rate during the life of the contract

        ii. an allocation determined directly by the performance of specified assets

35. At the 04 May 2011 joint board meeting, the boards requested that the staff explore whether an account balance should be deemed explicit when withdrawals from that balance do not affect the level of insurance coverage. While this characteristic is often seen in explicit account balances, we do not believe that it is a defining feature. For example, variable universal life contracts which have explicit account balances, are sometimes structured so that the amount of the insurance coverage fluctuates as the value of the account balance changes and other times are structured such that the insurance coverage is independent of changes in the

account balance. The staff believes that including a criterion that linking changes in the account value to the amount of insurance coverage would lead to product structuring opportunities and would not serve the intended purpose of the criteria, which is to distinguish explicit account balances from implicit account balances.

***Results of applying the separation criteria from the revenue recognition project***

36. The criteria in the revenue recognition project for identifying separate performance obligations are as follows:

> 27. If an entity promises to transfer more than one good or service, the entity shall account for each promised good or service as a separate performance obligation only if it is distinct. If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in an entity accounting for all the goods or services promised in a contract as a single performance obligation.
>
> 28. Except as specified in paragraph 29, a good or service is distinct if either of the following criteria is met:
>     a. The entity regularly sells the good or service separately.
>     b. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer. Readily available resources are goods or services that are sold separately (by the entity or by another entity), or resources that the customer already has obtained (from the entity or from other transactions or events).
>
> 29. Notwithstanding the requirements in paragraph 28, a good or service in a bundle of promised goods or services is not distinct and, hence, the entity shall account for the bundle as a single performance obligation, if both of the following criteria are met:
>     a. The goods or services in the bundle are highly interrelated and transferring them to the customer requires the entity also to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted.
>     b. The goods or services are significantly modified or customized in order to fulfill the contract.
>
> 30. As a practical expedient, an entity may account for two or more distinct goods or services as a single performance obligation if those goods or services have the same pattern of transfer to the customer.

37. As it would apply to insurance contracts, the staff envisions that the above guidance would be edited to read as follows:

> 27. An insurer should account for explicit account balances as separate components of an insurance contract only if they are distinct.
> 28. Except as specified in paragraph 29, an explicit account balance is distinct if either of the following criteria is met:
>     a. The insurer regularly issues separately a financial instrument with the same rights and obligations as the explicit account balance (ie it issues unit-linked/variable contracts with no insurance risk and those contracts credit returns at the same rate as the bundled contract)
>     b. The policyholder can benefit from the explicit account balance on its own (ie the policyholder can benefit from investment returns)
> 29. Notwithstanding the requirements in paragraph 28, an explicit account balance is not distinct if the insurer's exposure to insurance risk in the combined contract is highly interrelated with its exposure to the financial risks arising from the account balance. In order to determine whether or not an account balance is highly interrelated with the remainder of the contract, an insurer should assess whether the amount of insurance risk the insurer is exposed to is significantly affected by the investment performance of the account balance.

38. Based on the staff's analysis of what types of contracts would be unbundled under the revenue recognition criteria (see appendix C), we note the following:

    a. Many contracts that contain explicit account balances would not be unbundled. Generally, the only contracts that would be unbundled are those variable or unit-linked contracts where changes in the account balances do not directly impact the amount of the insurance coverage. This would mean that the inflows and outflows to some explicit account balances (ie those that are not unbundled) would be presented as premiums and benefit payments, respectively, in an insurer's financial statements. Some board members stated that this would be misleading because it would fail to distinguish premiums for insurance coverage from deposits to an account balance.

    b. There would not be consistency across or even within product offerings about which contracts would be unbundled. For instance, a variable universal life contract would be unbundled if the amount of the insurance coverage is independent of changes in the account balance; however, that same contract would not be unbundled if the insurance coverage fluctuated as the value of the

account balance changed. In the latter scenario, the account balance would be deemed to be highly interrelated with the insurance coverage under the second criterion from the revenue recognition criteria. That criterion indicates that a bundle of goods or services is not distinct, and therefore should not be separated, if the entity performs a significant service of integrating the goods or services. As this would apply to insurance contracts, the staff interpreted this criterion to mean that if the insurance risk within a contract can be affected by changes in the account balance (ie investment risk) then the two components are highly interrelated. This notion of 'inseparable risks' was maintained by the boards in the most recent preballot draft for the proposed revenue recognition standard; however, the language was redrafted in a manner that would be clearer to readers of the guidance. For the purposes of applying such guidance to insurance contracts, the staff believes that our previous interpretation remains consistent with the spirit of the revenue recognition guidance despite the wording changes. BC76 in the basis for conclusions for the most recent revenue recognition exposure draft states:

> Although the Boards considered that the existence of separable risks indicated that a good or service is distinct, the Boards decided that, given the feedback on the 2010 proposed Update, the concept of inseparable risks may not be an intuitive or practical criterion for determining whether a good or service is distinct.

39. Based on our analysis, the staff do not believe that additional criteria should be used to determine whether an explicit account balance should be separated from the insurance contract liability. Many have argued that the most important function of any possible separation of account balances is to isolate the premiums received and distributions paid from deposit-type balances from those that relate to an insurer's insurance operations. The staff believe that the criteria for identifying 'explicit account balances' are sufficient in this regard and therefore that all explicit account balances should be separated from the insurance contract liability.

**Questions #1 and #2 for the boards- Explicit account balances**

**Q1**- Do the boards agree that all explicit account balances should be separated from the insurance contract liability?

**Q2**- Do the boards agree with the following criteria for identifying explicit account balances?

A contract has an explicit account balance if both of the following conditions are present:

A- The balance is an accumulation of the monetary amount of transactions between the policyholder and the insurer.

B- The balance is credited with an explicit return. A return is explicit if it is determined by applying either of the following to the balance:

(1) A contractual formula in which the insurer may have the ability to reset the return rate during the life of the contract

(2) An allocation determined directly by the performance of specified assets

***Should explicit account balances and the related assets be recognised in an insurer's financial statements?***

40. Before determining how to measure the disaggregated explicit account balance, the boards should determine whether or not the explicit account balance and the related assets should be recognized in an insurer's financial statements. In order to make this determination, the staff has reviewed the definitions of 'asset' and 'liability' from the IASB's conceptual framework and analyzed whether or not account balances and the related assets meet the definition and recognition criteria. The staff note that the definitions in the FASB's conceptual framework do not differ to the point where the conclusions would change. In conducting our analysis, the staff had in mind any and all explicit account balances. That is, we analyzed, for example, legally segregated accounts (eg separate accounts, unit-linked funds, segregated funds) no differently than account balances backed by the

general investments of the insurer. Based on the analysis, we concluded that explicit account balances are liabilities of the insurer and the assets backing those liabilities are assets of the insurer.

41. The staff's conclusions were based on the following, as detailed further in appendix B:

a. Account balances are liabilities of an insurer because:

   i. the insurer is legally obligated to pay the policyholder

   ii. the obligation represented by the account balance arises from the creation of the insurance contract

   iii. the amount of the liability can be reliably measured

b. Investments that back an account balance are assets to an insurer because:

   i. the insurer legally owns and controls such investments

   ii. the insurer will at some point utilize such assets to settle the insurance liability

such assets can generally be measured reliably ***Specific Considerations for Legally Segregated Accounts***

42. In some jurisdictions, insurers are required to establish a separate account which is a legally restricted fund that is segregated from the life insurance entity. Some argue that assets that are legally separated from those of the insurer (ie a specific subset of explicit account balances) should not be recognized in the insurer's balance sheet and that including them distorts the insurer's financial position. Supporters of this viewpoint believe that criteria in Topic 810- *Consolidation* (formerly SFAS 167- *Amendments to FASB Interpretation No. 46(R)*) requiring the entity to be "obligated to absorb losses that could potentially be significant to the other entity" and criteria in IFRS 10, *Consolidated Financial Statements,* which states that an investor controls (and should therefore consolidate) an investee only if the investor has "exposure, or rights, to variable returns from its involvement

with the investee" are not met when there is a separate account. However, the staff notes that a separate account is not a separate legal entity under general corporate statutes and the assets of the separate account are legally owned by the insurance enterprise and therefore the consolidation guidance would not apply.

43. In addition, the staff note that the notion of a separate account or something similar is based on jurisdictional laws regarding segregating the assets that are backing the insurance contract liability such that the separate account assets are isolated from the general creditors of the insurance entity. The staff do not believe that jurisdictional laws regarding the segregation of assets should impact the accounting for the insurance contract liability which could result in different accounting for identical insurance contracts.

44. Based on the above, the staff concluded that insurance contract liabilities that are backed by assets in a separate account and the separate account assets should be reported in the statement of financial position of the insurance enterprise that owns the assets and is contractually obligated to settle the liabilities consistent with the treatment of similar products that do not have legally segregated assets.

***Offsetting of the Account Balance and Related Assets***

45. If the assets and liabilities are recorded in the insurer's financial statements, some have questioned whether the balances should be offset. In redeliberations for the balance sheet offsetting project at the 14 June 2011 joint board meeting, the boards tentatively decided on differing approaches for determining when financial assets and financial liabilities can be offset against each other. The decisions of the boards differed primarily as they pertained to offsetting of derivatives, particularly those that are covered by a master netting agreement. For the purpose of determining whether an account balance and the related assets should be offset, the divergence between the boards' decisions is irrelevant. Under both the IASB and FASB approaches, financial assets and financial liabilities should be offset only when a right of setoff exists. This term is defined as follows:

a. FASB: A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.

b. IASB: A debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor.

46. In order for a right of setoff to exist, an entity must have the right to settle a contract at the net amount of a financial asset and a financial liability. This criterion would not be satisfied in the case of explicit account balances and the related assets.

    a. The insurer's obligation to the policyholder would be for the entire amount of the insurance liability. In addition to the account balance, the insurance liability could include obligations that relate to other components of the contract (ie the insurance component, guarantees that may be bifurcated and accounted for as a derivative, etc...). Distributing to the policyholder just the account balance then would not result in settlement of the entire insurance liability.

    b. Before an insurer would be able to remit funds to a policyholder, it would have to first liquidate the assets backing the liability. In order to liquidate such assets, the insurer would have to involve a third party in the transaction. Under both the FASB and IASB criteria above, the necessity to involve a third party would mean that a right of setoff does not exist, as both sets of criteria specify that the debtor (ie the insurer) must have a legal right to settle its obligation to the creditor (ie the policyholder) with amounts owed the debtor by the creditor as part of other arrangements.

47. While some insurance contracts directly link the explicit account balance to a pool of assets, other contracts do not. Rather, the assets backing the liabilities are part of the general account of the insurer. The staff agree with the argument by some that it would be misleading to reduce an insurer's general investments by these explicit account balances. To apply offsetting only to contracts that are directly

linked to the explicit account balances would result in different accounting presentation for a subset of contracts with explicit account balances.

48. Because (a) the investment component does not represent the entirety of the insurance obligation (b) there is no relinquishment of ownership of assets but rather the execution of a contract pursuant to which the insurance enterprise agrees to pass through the account investment results to the policyholder and (c) the contract executed between the contract holder and the insurance enterprise creates an obligation of the insurance enterprise that is not defeased by the segregation of funds in a legally segregated separate account, the staff believe that the explicit account balance should not be offset with the assets backing the liability, whether legally segregated or not.

49. Based on the staff's analysis account balances are liabilities of an insurer and the related assets are assets of an insurer, however no right of setoff exists. Account balances should therefore be recognized in an insurer's financial statements and should not be offset against the related assets.

| **Question #3 for the boards- Recognizing explicit account balances in an insurer's financial statements** |
| --- |
| **Q3-** Do the boards agree that explicit account balances and the related assets should be recognized in an insurer's financial statements and that they should not be offset against each other? |

***Measurement and Presentation of Explicit Account Balances***

50. If explicit account balances and the related assets should be recognized in an insurer's financial statements, then the boards must decide how to measure and present such balances. The staff explored whether explicit account balances should be:

    a. Measured and presented as if they were standalone financial instruments in accordance with the financial instruments standard

b. Accounted for as part of an insurance contract but presented separately (ie disaggregated) under the insurance contracts standard and measured at:

   i. the account balance, or

   ii. the amount contractually payable on demand

***Should the explicit account balance be measured and presented in accordance with financial instruments guidance (ie unbundled to another standard)?***

51. If explicit account balances were accounted for as financial liabilities, the explicit account balance component could be measured differently from the insurance component as follows:

   a. Accounting for acquisition costs is different from financial instruments guidance based on both the FASB and IASB tentative decisions.

   b. If explicit account balances were accounted for as financial liabilities, such balances could be measured at amortized cost based on the tentative decisions of the boards in the financial instruments project. At the 31 May 2011 meeting, the FASB tentatively decided that "an entity [should] measure at amortized cost financial liabilities" except when such liabilities are held for transfer at inception or are short sales, in which case they should be measured at fair value. Similarly, the IASB tentatively decided that "financial liabilities should be measured at amortised cost if they are not held for trading, and if they do not have embedded derivative features".

   c. If measured at fair value, which both boards allow if specific criteria are met, the discount rate would reflect risks of the insurer, not necessarily the risk of what the insurer invests in. Those risks include time value, credit and uncertainty to the timing and amount of the cash flows. This won't necessarily be equivalent to the assets that the liability is directly linked to or on which the rate credited to the account value is based.

d. Consideration in the liability measurement of expected but uncertain cash flows (ie surrender charges, mortality and expense charges, etc) is required under the insurance contracts project but not for financial liabilities that are measured at amortized cost. Presumably, if the fair value option applies, the expected cash flows would be considered in the probability weighted estimates in a level 3 measurement.

52. In addition, the financial instruments guidance differs from the insurance contracts model in what it purports to represent. The financial instruments guidance purports to show how an entity's financial instruments affect its financial condition and how changes in such fair values have affected the entity historically. The insurance contracts model is an expected cash flow model that measures entire contracts and allocates income and expense over the life of such contracts. Feedback from respondents has indicated that applying the financial instruments guidance would be very costly as this is not how they measure these liabilities today. IT systems would need to be modified so that the individual components could be tracked and reported on separately. In addition, insurers would need to develop a methodology for estimating what portion of a particular cash flow relates to each component for purposes of allocation of various costs, many of which would benefit both the explicit account balance and the remaining insurance liability and thus could be arbitrary.

53. One of the disadvantages of an alternative that would unbundle explicit account balances to another standard (ie financial instruments) is that the separated component would no longer be accounted for with the remainder of the contract. The account balance would be accounted for under the financial instruments standard, while the remaining insurance component would be accounted for under the insurance contracts standard. The separated account balance as accounted for under financial instruments guidance would not be comparable with the remaining insurance component without reconciling back from one set of guidance to the other (particularly in light of the differences in the guidance as outlined above in

paragraphs 51 and 52). Simply, if explicit account balances were unbundled to another standard, the sum of the parts would not be equal the whole.

54. The staff believes that measuring explicit account balances under the financial instruments guidance would not faithfully represent the economics of an insurance contract where the policyholder can withdraw their account value on demand, and the resulting information therefore would not be particularly useful to users of the financial statements.

***Should the explicit account balance be measured with the insurance liability but disaggregated at the amount of the account balance or the amount contractually payable on demand?***

55. As an alternative to unbundling the explicit account balance and measuring and presenting it in accordance with the financial instruments guidance, the staff has explored ways of accounting for the entire contract under the insurance contracts standard; however, we continue to believe in the importance of isolating and separately measuring explicit account balances (ie deposit-like balances) and deducting the related cash inflows and outflows from the statement of comprehensive income.

56. For many insurance contracts, the explicit account balances are integral to the insurance contract liability. Many of the contracts that have explicit account balances have features that would not be recognized if not included in the measurement of the insurance contracts liability. For example, many of the contracts that have explicit account balances (as defined in the staff recommendation) contain various interrelated options and guarantees that either are not accounted for (until they are in the money or until a specific point in time) or which are accounted for but do not use current assumptions. These features are not accounted for under current U.S. GAAP which many see as one of the significant problems with today's accounting model. As such, the staff recommend that the insurance contract should be measured as a whole and the explicit account balance should be disaggregated rather than accounting for the explicit account balance

individually. The measurement of an explicit account balance is important information, particularly to those contracts that contain minimal insurance coverage (eg some universal life contracts). However, so that a user can truly analyze the effectiveness of an insurer's operations, the financial statements should also contain information about other elements of such contracts, including estimated cash flows and assumptions regarding policyholder behavior.

57. In order to determine whether disaggregation is a viable alternative the key questions are:

    a. How should disaggregated explicit account balances be measured?

    b. Should the measurement be different for account balances that are backed by a specific pool of assets as opposed to an insurer's general fund?

    c. What impact would cross-subsidies have on the measurement?

    d. How should fees for investment management services be accounted for?

    e. After disaggregating any explicit account balances, is the measure of the insurance component meaningful?

***Measurement of the Disaggregated Component (Amount Payable on Demand versus Account Balance)***

58. In order to meet the objectives discussed in previous board meetings, the staff explored whether the measurement of demand deposits (ie the amount payable on demand) could be applied to the disaggregated components.

    a. IFRS 9, *Financial Instruments,* Paragraph 5.4.3 states that the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

b. Under US GAAP, ASC Topic 825-10-55-33, *Financial Instruments*, the fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date.

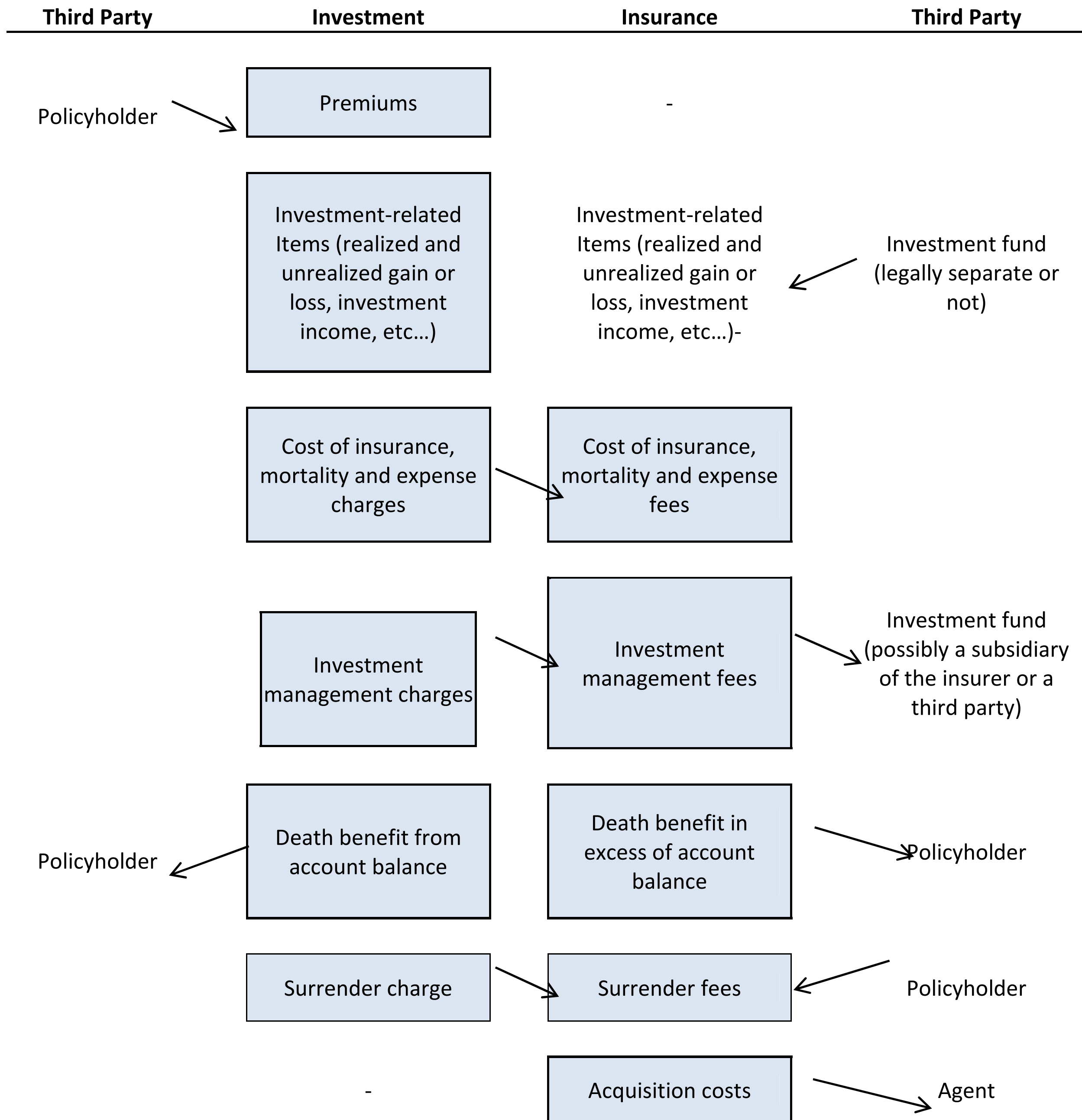
59. The staff also considered whether the measurement could be based on the account value. The only substantive difference between this measurement and the 'amount payable on demand' would be that surrender charges would not be deducted from the account balance in the former, whereas they would in the latter.

60. Below, the staff analyzes how "the amount payable on demand" and the account value would be applied to:

a. contracts with investment components backed by a separate portfolio of assets

b. contracts with investment components backed by the insurer's general fund

61. *Illustration of Cash Flow Allocations*



*Contracts with Investment Components Backed by a Separate Portfolio of Assets*

62. Some account balances are backed by a portfolio of assets such that the amount and timing of the cash flows to/from the liability will always mirror exactly those of the portfolio of assets. This includes premiums received and benefits paid that are passed directly to or from the portfolio of assets and then reflected in the account balance. In these situations, the account value is always equal to the cumulative amount of inflows to and outflows from the account balances since the underlying assets make up 100% of the account balance.

63. For account balances that are backed directly by specific assets (ie unit-linked accounts, segregated funds, separate accounts, etc...), the staff believe that such components should be measured at the account value. The advantages of this measurement (account value) over the 'amount contractually payable on demand' are (a) its simplicity and (b) that it results in a more meaningful residual insurance component. When determining the expected cash flows of a portfolio of insurance contracts, the insurer makes assumptions regarding how many contracts will be surrendered and when they will be surrendered. To extract the account value less surrender charges on a contract by contract basis would not be meaningful to the users of the financial statements and would overstate the remaining insurance liability.

*Contracts with Investment Components Backed by the Insurer's General Fund*

64. There are other explicit account balances that are backed by the assets in the insurer's general account, as opposed to a specific portfolio of assets as described above. However there are no specific assets backing the liability on which to base the measurement of such liabilities.

65. In order to measure this type of account balance, the staff has reviewed typical inflows and outflows to such account balances and analyzed whether or not such discrete cash flows should be attributable either entirely to the account balance or entirely to the insurance component. An insurer would isolate cash flows attributable to the insurance component and deduct them from the insurance

liability to arrive at the estimated value of the insurance component. Examples of which cash inflows/outflows would be attributable to each component of the insurance liability are shown in the table above at paragraph 61.

66. The illustration at paragraph 61 (which does not include all possible cash flows) illustrates which inflows/outflows would be allocable to the various components of a contract. The staff believe that the deposit component should again be measured based on the account value, which would be the value of the cumulative inflows/outflows allocable to the investment component (ie the explicit account balance).

67. Under both scenarios discussed above (when contracts with investment components are backed by a separate portfolio of assets or backed by the insurer's general fund), the staff recommendation results in the amount being recorded that equals the account value. That is, an amount equal to the contractual amount the policyholder would receive on any given day, ignoring surrender charges and inclusive of any accrued interest to which the policyholder would be entitled.

***What impact do cross-subsidies have on the measurement?***

68. The staff analyzed whether the effect of cross-subsidies should be considered when determining the balance that would be disaggregated. Some believe cross-subsidies should be considered when a provision in a contract is less than market value and another provision is greater than market value (ie one component of a contract reduces the cost to the policyholder of another component of the contract). In this situation it would be appropriate for an entity to consider the inter-related provisions together when determining the revenue or expense to recognize. Because the staff's recommended approach requires the insurance contract to be measured as a whole (ie considering all components) and the item being disaggregated is the amount that is owed to the policyholder on a specific day (ignoring potential policyholder behaviour), cross-subsidies would be offset within that measurement. However, if different measurement approaches were to

be used for the various components, cross-subsidies would potentially need to be considered.

***How should fees for investment management services be accounted for?***

69. Investment management services are inherent in the maintenance of an insurance contract that has explicit account balances that are credited with returns based on the performance of the investment portfolio. Some argue that the fees for the investment management services should be unbundled from fees for the insurance component and accounted for using the guidance for revenue recognition.

70. This could alleviate the insurers need to calculate the expected value of the fees (or cash inflows) which many times are based on the daily value of the account balance, for example . 0025% of the account balance per day. Under the revenue recognition guidance the insurer would recognize the fee income and the expenses when they are incurred.

71. One counter argument to unbundling of investment management fees is that fees for investment management services typically are not explicit and therefore an insurer would need to determine how to split the expense charge. For example, the investment management fee may be commingled with charges for administrative expenses and mortality and expense risks, all of which are typical expenses for activities to fulfil an insurance contract.

72. In addition, in applying the boards' tentative decision to measure the insurance contract liability using the expected cash flows, if an insurer did break out the expense charge the amount of the cash inflow would be included in the estimate of the expected cash outflow thus resulting in a nominal net amount.

73. Another counter argument to unbundling investment management fees is that in addition to the policyholder benefiting from effective investment management services, the insurer is benefiting as well. The insurer uses the investments and the related results to pay out claims. The amount of investment management services provided to the policyholder is minimal when the policyholder is directing the insurer on investing its premium; this is typically the case when the liability is

directly linked to a specific portfolio of assets. However, if the explicit account balance is not directly linked to a specific portfolio the claims are paid from the general fund investments and in these cases the investment management services are more significant.

74. Based on these factors the staff recommend that fees for investment management services not be unbundled from other expenses charged to the explicit account balances.

***How Meaningful is the Remaining Insurance Component?***

75. The staff believe that in order for the disaggregation of explicit account balances to be a viable alternative, we need to understand what the remaining insurance liability represents. As previously noted, the entire insurance contract would be measured using the building block approach which the boards tentatively decided would include:

   a. Unbiased probability weighted expected present value of cash flows
   b. Plus a risk adjustment and residual margin (IASB only) or
   c. Plus a single margin (FASB only)

76. If the explicit account balance is deducted from the measurement of the entire insurance contract, the remaining liability would represent the following (not all inclusive):

   a. Expected cash inflows to/from the insurer for assessments made against the explicit account balance including cost of insurance, surrender charges, and mortality and expense charges which are typically a percentage of the daily account value.
   b. Expected cash flows for:

i. assessments and mortality, morbidity, surrender, and lapse rate assumptions for the insurance component

ii. assumptions related to future annuitization options or other elective benefit options

iii. assumptions related to guarantee features that aren't bifurcated as embedded derivatives

c. Acquisition costs that meet certain criteria

d. Risk adjustment and residual margin (IASB only)

e. Single margin (FASB only)

77. Some would argue that the remaining liability is not representative of the stand-alone insurance component for the following reasons:

a. If acquisition costs are significant, the insurance component could be an asset. Conceptually, there is nothing improper about this result; however, it might be unanticipated and some preparers and users may be uncomfortable with presenting the insurance component as an asset.

b. The insurance liability measures the expected cash flows at a discounted amount. If an insurer disaggregates an explicit account balance using assumptions that differ from the assumptions used to determine the insurance liability under the building block approach (ie different discount rates), the difference (or balancing item) is left in the remaining insurance component. Changes in the balancing item between periods (when the explicit account balance is based on the amount payable on demand) would be difficult to explain.

i. The discount rate applied to the overall insurance contract liability will be based on the characteristics of the liability. If the explicit account balance is directly linked to a portfolio of assets and therefore is measured based on the assets' market values, the asset discount rate for

the market value will be reflective of the contractual cash flows of the assets. These two discount rates will differ.

ii. The duration of the expected weighted cash flows most likely will be longer than the contractual cash flows of the assets. The explicit account balance then would be deducted using a measurement that would be inconsistent with the measurement of the insurance liability.

The staff acknowledges this concern; however, we believe that presentation of the account balance at the contractually due amount is a more useful measure. If the account balance were discounted using the same rate as the insurance liability, the result would be that the disaggregated account balance would be different than the amount contractually payable.

c. For some contracts the fees charged to the explicit account balance, which is income to the insurer, are based on the value of the account balance which may be directly linked to assets. Estimating expected cash flows on this piece would require the use of a market-consistent measurement which could result in significant volatility in the statement of comprehensive income as a result of market movements as opposed to underwriting results. The staff considered whether the liability should ignore expected cash inflows to/from the insurer for assessments made against the explicit account balance that are based on market values, however, we concluded that this would be an issue regardless of any decision to disaggregate explicit account balances and it should be addressed separately from this paper if it is deemed necessary.

d. The staff also considered whether to allocate portions of the discrete expected cash inflows and outflows (charges) to the explicit account balance measured as recommended in this paper (based on the account value). Such charges would include, for example, portions of the acquisition costs, asset management fees, loads, and mortality/expense charges. The staff believe that this process would be arbitrary and cumbersome (ie costs would outweigh benefits) as well as being prone to management error and/or bias. Furthermore,

if an insurer allocated cash flows in such a manner, the resulting measurement would not approximate the amount payable to the policyholder, which is one of the primary objectives of separating account balances.

78. Based on the analysis in this section, the staff believe that the remaining liability after disaggregating the explicit account balance would meaningfully represent the total bundle of remaining rights and obligations of the insurer under the contract.

79. In addition, the staff believe that this alternative would result in useful information being presented at a much lower cost to the preparer than other alternatives previously discussed. This approach would minimize (a) the subjectivity of the allocations that would have to be performed and (b) eliminate the systems modifications that would be required by the preparer so that it could isolate its deposit components and account for them under a different standard. As noted above, in their responses to the ED and the DP, many constituents noted that, for exactly those reasons, the costs associated with unbundling to another standard would be overly burdensome and would outweigh the benefits.

***Previous Concerns about a Similar Methodology- Why the Staff Believe this Alternative is Different***

80. In 2007 the IASB published a discussion paper, *Preliminary Views on Insurance Contracts* (the 'IASB DP'), that proposed a methodology for separating investment components that was similar to the methodology proposed in this paper. The IASB DP required an insurer to separate deposit components (ie account values) from an insurance component in the following manner.

   a. If the components are so interdependent that the components can be measured only on an arbitrary basis, the phase II standard on insurance contracts should apply to the whole contract.

   b. If the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The whole

contract would be measured by applying the phase II standard. Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component.

81. Responses to this proposal in the IASB DP was decidedly negative; however, much of the criticism of the proposed methodology centered on issues that have been modified, remedied, or considered by the staff in forming our recommendations in this paper. In the comment letter summary for the IASB DP, the staff documented the following:

> Respondents agreed with (a) but many respondents disagreed with (b) [See paragraph 80]. They argued that:
>
> 1- The terms *interdependent* and *arbitrary* are unclear, so there would be variation in practice.
> 2- Splitting the measurement in this way would be costly.
> 3- The resulting measurement of the insurance component as a residual would not be a faithful representation and would not provide useful information to users.

82. The staff has considered this commentary in forming the recommendation in this paper. We do not believe that findings 1 and 2 (as numbered above) would remain problematic in light of the methodology proposed in this paper.

a. The terms *interdependent* and *arbitrary* are not cited in our recommendation, nor are there any plans to introduce such terminology.

b. The IASB DP proposed guidance that would measure the account balance under IAS 39, which would have required an allocation of costs and a different measurement than that used for the insurance contract liability. Under the recommendation in this paper, the account balance would be measured at the cumulative amount of the inflows and outflows to the account balance, which

would be a sub-component of the insurance contract liability and would not require an allocation of costs.

c. In the opinion of the staff, the primary advantage of the disaggregation alternative proposed in this paper over unbundling or any other previous recommendations is that it would be comparatively inexpensive to implement. This alternative would minimize required systems changes. Furthermore, it would eliminate the need for an insurer to perform complex allocations of cash flows between an investment component and an insurance component. Instead, these cash flows would be allocable entirely either to one component or the other. Refer to paragraph 61 for further illustration.

83. The staff is sensitive to respondents' comments that the residual insurance component would not be meaningful. The model that was presented in the IASB DP in 2007 differed significantly from that which has been tentatively decided on by the boards (the IASB DP proposal was predicated on an exit-value notion and was based on market-participant data). The staff acknowledges that there will continue to be some questions on the meaning of the remaining liability which the staff have documented in paragraphs 75 - 79.

## Staff Recommendation

84. The staff recommend that explicit account balances should be accounted for as part of the insurance contract but they should be separately presented and measured at the account value. The insurance liability therefore would be measured as the residual of the building blocks insurance contract liability less the account balance(s). We believe that this approach would be more cost-effective than unbundling to another standard, and that the resulting financial information would be transparent and therefore beneficial to users.

85. Users would be able to separately identify explicit account balances that are contractually available to a policyholder from the insurance liability that

represents expected cash flows for which the insurer is exposed to the risk of uncertainty.

86. Furthermore, compared with the other alternatives considered, this alternative would be minimally disruptive from both a systems and a reporting standpoint. Because deposit-type account balances would be disaggregated from the insurance component, there would be no need for insurers to go through complex and ultimately arbitrary allocation processes to separate the investment component from the various other components.

**Questions #4 and #5 for the boards- Disaggregation of explicit account balances**

**Q4**- Do the boards agree that an insurer should measure explicit account balances and services associated with explicit account balances (eg asset management services), if any, together with the other components of insurance contracts?

**Q5**- Do the boards agree that explicit account balances should be presented separately from the insurance contracts liability on the face of the statement of financial position (rather than in the notes to the financial statements) at an amount equal to the sum of:

i. the explicit account balance, and
ii. an accrual for all fees and returns through the reporting date.

Furthermore, the measurement of the explicit account balances should not include expected future cash inflows or outflows whether contractual or based on policyholder behavior (eg surrender charges).

***Presentation in the Income Statement of Changes in the Explicit Account Balance***

87. To determine whether and/or how an insurer should recognize income and expenses related to explicit account balances, the staff has compared typical inflows and outflows to such account balances with their definitions in the IFRS

conceptual framework. Note that the definitions of the elements and conditions necessary for recognition do not differ under the FASB conceptual framework to the point where the analysis would be affected. The following chart breaks down the various inflows/outflows into subsets based on which component they would likely affect:

| Element | Subset | Component | Examples |
|---|---|---|---|
| Income | Type 1 | Insurance | - Management fees for internally managed funds<br>- Loads<br>- Cost of insurance (COI) |
| | Type 2 | Investment | - Premiums received<br>- Dividends, interest income, realized gains/losses credited to the account balance |
| Expense | Type 1 | Insurance | - Death benefit (in excess of account balance)<br>- Commissions<br>- Other acquisition costs<br>- Maintenance expenses |
| | Type 2 | Investment | - Death benefit (below account balance)<br>- Withdrawals<br>- Surrenders<br>- Fees paid to managers<br>- Dividends, interest income, realized gains/losses credited to the policyholder |

88. The following analyses examine whether the subsets identified above meet the definitions of the various elements of financial statements identified in the conceptual framework(s) from the perspective of the insurer. That is, would such activities be income and expenses of the insurer?

| Definition of Income (Conceptual Framework Paragraph 4.25(a)) | Subset | Generally Satisfied? |
|---|---|---|
| Income is increases in economic benefits during the accounting period in the form of: | Type 1 | - Yes. These fees to the explicit account balance represent inflows of assets to the insurer. |

| | | |
|---|---|---|
| - inflows or enhancements of assets or<br>- decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. | | |
| | Type 2 | - No. Explicit account balances are credited with premiums and investment performance (interest, dividends, realized and unrealized gains). Although premiums act to increase the asset or decrease the liability, they are contractually due to the policyholder and therefore not inflows of economic benefits to the insurer and do not result in an increase in equity.<br>- However, in the case of investment income there is no direct pass-though. This type of income accrues to the insurer's assets and is then allocated to the policyholder's account, meaning that it is income to the insurer. |
| **Recognition of Income (Conceptual Framework Paragraph 4.47)** | **Subset** | **Generally Satisfied?** |
| Income is recognized in the income statement when an increase in future economic benefits related to an increase in an asset **or** a decrease of a liability has arisen that can be measured reliably.<br><br>Recognition of income occurs simultaneously with the recognition of increases in assets **or** decreases in liabilities. | Type 1 | - Yes. Fees charged to policyholders for internally managed functions reflect an increase in assets of the insurer and can be measured reliably (ie per the contract). |
| | Type 2 | - Yes. Investment performance (interest, dividends, realized and unrealized gains) can be measured reliably and accrues to the account balances, which are assets of the insurer. |

| Definition of Expense (Conceptual Framework Paragraph 4.25(b)) | Subset | Generally Satisfied? |
|---|---|---|
| Expenses are decreases in economic benefits during the accounting period in the form of:<br><br>- outflows or depletions of assets or<br>- Incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. | Type 1 | - Yes. Incurrence of acquisition or startup costs initially is an outflow or creates a liability for the insurer. |
| | Type 2 | - Yes. These outflows are a function of the investment component and result in depletion of those assets. Investment income and realized gain/loss is shown as investment income to the insurer; amounts credited to the policyholder should be shown as expenses of the account balance. Death benefits should be shown as expenses of the account balance except in cases where the death benefit exceeds the account value. |
| **Recognition of Expense (Conceptual Framework Paragraph 4.48)** | **Subset** | **Generally Satisfied?** |
| Expenses are recognized in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.<br><br>Recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets. | Type 1 | - Yes. Acquisition costs are (1) increases in liabilities if accrued or (2) decrease in assets if paid immediately that can be measured reliably (ie per the contract and/or by actuarial valuation technique). |
| | Type 2 | - No. Recognition of transaction costs and fees paid to managers or brokers does not increase liabilities |

| | | |
|---|---|---|
| | | or decrease assets of the insurer. |

89. Based on the analysis performed in the table above, an insurer's income statement should be affected by inflows to and outflows from explicit account balances as follows:

   a. Type 1 activities (from above): Revenues (ie management fee income charged to policyholders for internally managed funds, cost of insurance, mortality and expense charges, etc...) and expenses (ie commissions, other acquisition costs, etc...) associated with explicit account balances should be presented in an insurer's statement of comprehensive income.

   b. Type 2 activities (from above):

      i. Premiums received, death benefits for less than the account balance, distributions, and surrenders should not be recognized in an insurer's statement of comprehensive income. The staff believe that excluding these items of income and expense would be:

         1. more beneficial to users in that they would be able to more readily analyze investment returns of insurance enterprises by excluding amounts that are not available to shareholders, and

         2. representationally faithful of an insurer's actual underwriting results.

90. In addition to the reasons highlighted in the table above, the staff notes the following:

   a. Premiums received accrue directly to the policyholder's balance and are considered by some to be a form of advance funding, as opposed to revenues. Distributions from such account balances are a return of policyholder account balances and are therefore not expenses.

b. The amount of the related balance sheet accounts (ie explicit account balances and related assets) could be of interest to users for assessing the significance of such balances to an insurer's overall operations. However, details of the inflows and outflows to such balances are irrelevant because they are not reflective of the insurer's underwriting operations.

c. In regards to investment income and interest credits, there are two different views:

   i. Some believe the most meaningful presentation would be to net the investment income and expenses to zero. The AICPA articulated this rationale as it pertained to legal separate accounts in SOP 03-1 as follows:

   "...the offsetting of investment performance and corresponding amounts credited to the contract holder provide the most meaningful presentation to the users of financial statements… that presentation allows financial statement users to more readily analyze investment returns of insurance enterprises by excluding amounts that are legally insulated from the general account and not available to shareholders."

   ii. Conversely, some believe investment income (ie interest and dividend income, unrealized gains and losses, and realized gains and losses) generated by explicit account balances should be included in an insurer's statement of comprehensive income. Although this type of activity does pass through to the policyholder, it is first allocated to the assets of the insurer. The insurer then allocates the performance to the policyholder's account balance. Furthermore, this information is useful in determining how well an insurer manages its assets, a measure that is reported to the policyholder. Although in some cases the policyholder chooses their investment strategy, the insurer is responsible for either actually managing the assets or selecting the investment manager. In addition, excluding the investment income for

explicit account balances when the assets are on an insurer's statement of financial position would result in misleading investment yields on the insurer's assets.

91. To summarize the above:

    a. The account balance is like a deposit. Payments in by the policyholder are deposit receipts and payments out are deposit withdrawals. Therefore, these transactions should not be included in the statement of comprehensive income.

    b. Charges to the policyholder account are consideration for insurance coverage and, if applicable, other services provided to the policyholder (ie asset management services provided by the insurer which are activities to fulfil the insurance obligation) and therefore should be included in the statement of comprehensive income.

    c. Returns on the insurer's assets are investment returns and interest credited to the policyholder is interest expense and should be presented as such (separately) in the statement of comprehensive income.

92. Based on the above, users would see only the transactions that are generated by or expensed as a result of the insurer's underwriting operations or investment activities. An insurer's statement of comprehensive income would not include as income or expenses activities that are really nothing more than the receipt and repayment of deposits from policyholders.

**Question #6 for the boards- Effect on the statement of comprehensive income**

**Q6**- Do the boards agree that:

Premiums accumulated in explicit account balances and claims paid or withdrawals from explicit account balances should not be recognised in the statement of comprehensive income.

The following (including any related accruals) should be recognised in the statement of comprehensive income:

i. any fees deducted from explicit account balances
ii. investment returns on an insurer's assets regardless of whether or not the explicit account balance is linked to those assets
iii. interest credited to explicit account balances

## Appendix A- Typical Lifecycle of a Long-Duration Contract from Inception

**Fact Pattern:** Contract is a whole life policy with an initial death benefit of 250,000 USD. The death benefit increases each year by the amount of the premiums paid that are not needed to pay current expenses, death claims, or future benefits. These are termed "paid-up additions" and become a permanent part of the death benefit once credited. Policyholder is a 35 year-old male non-smoker. Per the terms of the contract, premiums are due annually in the amount of $3,042.50. This amount includes annual payments of 87.50 USD for a disability waiver. This rider is unavailable after age 65. Thereafter, annual premiums for the policy will equal 2,955 USD. Cash surrender value is the amount payable if the policyholder surrenders the policy prior to death. Any loans or withdrawals are netted against the policy value to arrive at the cash surrender value. When the policyholder reaches age 121, the policy will mature and the guaranteed cash value will equal the policy's face amount.

| Year of policy | Age | Current required premium | Policy Cash Flow | Guaranteed Policy Cash Values | Cash Value of Paid-Up Additions | Cash Surrender Value | Annual Cash Value increase | Face Amount of Paid-Up Additions | Death Benefit | Cumulative Premiums |
|---|---|---|---|---|---|---|---|---|---|---|
| 1 | 36 | 3,043 | 3,043 | 0 | 0 | 0 | 0 | 0 | 250,000 | 3,043 |
| 2 | 37 | 3,043 | 3,043 | 0 | 58 | 58 | 58 | 0 | 250,000 | 6,086 |
| 3 | 38 | 3,043 | 3,043 | 1,730 | 191 | 1,921 | 1,863 | 255 | 250,255 | 9,129 |
| 4 | 39 | 3,043 | 3,043 | 4,398 | 357 | 4,755 | 2,834 | 816 | 250,816 | 12,172 |
| 5 | 40 | 3,043 | 3,043 | 7,400 | 559 | 7,959 | 3,205 | 1,473 | 251,473 | 15,215 |
| 6 | 41 | 3,043 | 3,043 | 10,785 | 798 | 11,583 | 3,624 | 2,232 | 252,232 | 18,258 |
| 7 | 42 | 3,043 | 3,043 | 14,258 | 1,096 | 15,354 | 3,770 | 3,078 | 253,078 | 21,301 |
| 8 | 43 | 3,043 | 3,043 | 17,818 | 1,457 | 19,275 | 3,922 | 4,083 | 254,083 | 24,344 |
| 9 | 44 | 3,043 | 3,043 | 21,468 | 1,884 | 23,352 | 4,077 | 5,249 | 255,249 | 27,387 |
| 10 | 45 | 3,043 | 3,043 | 25,195 | 2,387 | 27,582 | 4,230 | 6,561 | 256,561 | 30,430 |
| 11 | 46 | 3,043 | 3,043 | 28,390 | 2,991 | 31,381 | 3,798 | 8,039 | 258,039 | 33,473 |
| 12 | 47 | 3,043 | 3,043 | 31,665 | 3,703 | 35,368 | 3,987 | 9,744 | 259,744 | 36,516 |

| Year of policy | Age | Current required premium | Policy Cash Flow | Guaranteed Policy Cash Values | Cash Value of Paid-Up Additions | Cash Surrender Value | Annual Cash Value increase | Face Amount of Paid-Up Additions | Death Benefit | | Cumulative Premiums |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 13 | 48 | 3,043 | 3,043 | 35,020 | 4,524 | 39,544 | 4,176 | 11,674 | 261,674 | | 39,559 |
| 14 | 49 | 3,043 | 3,043 | 38,485 | 5,444 | 43,929 | 4,386 | 13,805 | 263,805 | | 42,602 |
| 15 | 50 | 3,043 | 3,043 | 42,060 | 6,478 | 48,538 | 4,609 | 16,084 | 266,084 | | 45,645 |
| 16 | 51 | 3,043 | 3,043 | 45,743 | 7,639 | 53,382 | 4,843 | 18,526 | 268,526 | | 48,688 |
| 17 | 52 | 3,043 | 3,043 | 49,523 | 8,947 | 58,470 | 5,089 | 21,148 | 271,148 | | 51,731 |
| 18 | 53 | 3,043 | 3,043 | 53,385 | 10,427 | 63,812 | 5,342 | 23,986 | 273,986 | | 54,774 |
| 19 | 54 | 3,043 | 3,043 | 57,330 | 12,089 | 69,419 | 5,607 | 27,076 | 277,076 | | 57,817 |
| 20 | 55 | 3,043 | 3,043 | 61,343 | 13,962 | 75,305 | 5,885 | 30,418 | 280,418 | | 60,860 |
| 21 | 56 | 3,043 | 3,043 | 65,408 | 16,067 | 81,475 | 6,170 | 34,054 | 284,054 | | 63,903 |
| 22 | 57 | 3,043 | 3,043 | 69,530 | 18,414 | 87,944 | 6,470 | 38,011 | 288,011 | | 66,946 |
| 23 | 58 | 3,043 | 3,043 | 73,705 | 21,024 | 94,729 | 6,785 | 42,276 | 292,276 | | 69,989 |
| 24 | 59 | 3,043 | 3,043 | 77,968 | 23,879 | 101,847 | 7,119 | 46,862 | 296,862 | | 73,032 |
| 25 | 60 | 3,043 | 3,043 | 82,313 | 27,000 | 109,313 | 7,465 | 51,691 | 301,691 | | 76,075 |
| 26 | 61 | 3,043 | 3,043 | 86,723 | 30,411 | 117,134 | 7,822 | 56,775 | 306,775 | | 79,118 |
| 27 | 62 | 3,043 | 3,043 | 91,175 | 34,151 | 125,326 | 8,191 | 62,146 | 312,146 | | 82,161 |
| 28 | 63 | 3,043 | 3,043 | 95,645 | 38,252 | 133,897 | 8,572 | 67,857 | 317,857 | | 85,204 |
| 29 | 64 | 3,043 | 3,043 | 100,118 | 42,743 | 142,861 | 8,964 | 73,953 | 323,953 | | 88,247 |
| 30 | 65 | 3,043 | 3,043 | 104,600 | 47,641 | 152,241 | 9,380 | 80,460 | 330,460 | | 91,290 |
| 31 | 66 | 2,955 | 2,955 | 109,095 | 52,967 | 162,062 | 9,822 | 87,374 | 337,374 | | 94,245 |
| 32 | 67 | 2,955 | 2,955 | 113,613 | 58,749 | 172,362 | 10,299 | 94,703 | 344,703 | | 97,200 |
| 33 | 68 | 2,955 | 2,955 | 118,170 | 64,996 | 183,166 | 10,804 | 102,451 | 352,451 | | 100,155 |

| Year of policy | Age | Current required premium | Policy Cash Flow | Guaranteed Policy Cash Values | Cash Value of Paid-Up Additions | Cash Surrender Value | Annual Cash Value increase | Face Amount of Paid-Up Additions | Death Benefit | Cumulative Premiums |
|---|---|---|---|---|---|---|---|---|---|---|
| 34 | 69 | 2,955 | 2,955 | 122,770 | 71,726 | 194,496 | 11,330 | 110,598 | 360,598 | 103,110 |
| 35 | 70 | 2,955 | 2,955 | 127,423 | 78,939 | 206,362 | 11,866 | 119,134 | 369,134 | 106,065 |
| 36 | 71 | 2,955 | 2,955 | 132,108 | 86,644 | 218,752 | 12,390 | 128,021 | 378,021 | 109,020 |
| 37 | 72 | 2,955 | 2,955 | 136,818 | 94,865 | 231,683 | 12,930 | 137,256 | 387,256 | 111,975 |
| 38 | 73 | 2,955 | 2,955 | 141,483 | 103,692 | 245,175 | 13,492 | 146,851 | 396,851 | 114,930 |
| 39 | 74 | 2,955 | 2,955 | 146,118 | 113,148 | 259,266 | 14,091 | 156,973 | 406,973 | 117,885 |
| 40 | 75 | 2,955 | 2,955 | 150,730 | 123,259 | 273,989 | 14,723 | 167,611 | 417,611 | 120,840 |
| 41 | 76 | 2,955 | 2,955 | 155,315 | 134,059 | 289,374 | 15,385 | 178,771 | 428,771 | 123,795 |
| 42 | 77 | 2,955 | 2,955 | 159,873 | 145,569 | 305,442 | 16,068 | 190,477 | 440,477 | 126,750 |
| 43 | 78 | 2,955 | 2,955 | 164,373 | 157,828 | 322,201 | 16,759 | 202,726 | 452,726 | 129,705 |
| 44 | 79 | 2,955 | 2,955 | 168,785 | 170,876 | 339,661 | 17,460 | 215,574 | 465,574 | 132,660 |
| 45 | 80 | 2,955 | 2,955 | 173,075 | 184,758 | 357,833 | 18,172 | 229,081 | 479,081 | 135,615 |
| 46 | 81 | 2,955 | 2,955 | 177,240 | 199,517 | 376,757 | 18,924 | 243,317 | 493,317 | 138,570 |
| 47 | 82 | 2,955 | 2,955 | 181,248 | 215,204 | 396,452 | 19,695 | 258,328 | 508,328 | 141,525 |
| 48 | 83 | 2,955 | 2,955 | 185,125 | 231,839 | 416,964 | 20,513 | 274,194 | 524,194 | 144,480 |
| 49 | 84 | 2,955 | 2,955 | 188,875 | 249,454 | 438,329 | 21,365 | 290,905 | 540,905 | 147,435 |
| 50 | 85 | 2,955 | 2,955 | 192,488 | 268,084 | 460,572 | 22,243 | 308,474 | 558,474 | 150,390 |
| 51 | 86 | 2,955 | 2,955 | 195,933 | 287,768 | 483,701 | 23,129 | 326,955 | 576,955 | 153,345 |
| 52 | 87 | 2,955 | 2,955 | 199,193 | 308,503 | 507,696 | 23,996 | 346,424 | 596,424 | 156,300 |
| 53 | 88 | 2,955 | 2,955 | 202,248 | 330,339 | 532,587 | 24,891 | 366,903 | 616,903 | 159,255 |
| 54 | 89 | 2,955 | 2,955 | 205,095 | 353,328 | 558,423 | 25,837 | 388,488 | 638,488 | 162,210 |

| Year of policy | Age | Current required premium | Policy Cash Flow | Guaranteed Policy Cash Values | Cash Value of Paid-Up Additions | Cash Surrender Value | Annual Cash Value increase | Face Amount of Paid-Up Additions | Death Benefit | Cumulative Premiums |
|---|---|---|---|---|---|---|---|---|---|---|
| 55 | 90 | 2,955 | 2,955 | 207,733 | 377,441 | 585,174 | 26,750 | 411,253 | 661,253 | 165,165 |
| 56 | 91 | 2,955 | 2,955 | 210,165 | 402,658 | 612,823 | 27,649 | 435,195 | 685,195 | 168,120 |
| 57 | 92 | 2,955 | 2,955 | 212,480 | 429,160 | 641,640 | 28,818 | 460,312 | 710,312 | 171,075 |
| 58 | 93 | 2,955 | 2,955 | 214,695 | 457,031 | 671,726 | 30,085 | 486,698 | 736,698 | 174,030 |
| 59 | 94 | 2,955 | 2,955 | 216,820 | 485,956 | 702,776 | 31,050 | 514,431 | 764,431 | 176,985 |
| 60 | 95 | 2,955 | 2,955 | 218,870 | 515,928 | 734,798 | 32,022 | 543,180 | 793,180 | 179,940 |
| 61 | 96 | 2,955 | 2,955 | 220,863 | 546,877 | 767,740 | 32,942 | 572,973 | 822,973 | 182,895 |
| 62 | 97 | 2,955 | 2,955 | 222,943 | 578,876 | 801,819 | 34,079 | 603,791 | 853,791 | 185,850 |
| 63 | 98 | 2,955 | 2,955 | 225,208 | 611,918 | 837,126 | 35,307 | 635,555 | 885,555 | 188,805 |
| 64 | 99 | 2,955 | 2,955 | 227,825 | 645,970 | 873,795 | 36,669 | 668,281 | 918,281 | 191,760 |
| 65 | 100 | 2,955 | 2,955 | 231,093 | 680,906 | 911,999 | 38,204 | 701,981 | 951,981 | 194,715 |
| 66 | 101 | 0 | 0 | 231,993 | 716,672 | 948,665 | 36,666 | 736,617 | 986,617 | 194,715 |
| 67 | 102 | 0 | 0 | 232,875 | 753,753 | 986,628 | 37,963 | 772,301 | 1,022,301 | 194,715 |
| 68 | 103 | 0 | 0 | 233,738 | 792,216 | 1,025,954 | 39,326 | 809,182 | 1,059,182 | 194,715 |
| 69 | 104 | 0 | 0 | 234,585 | 832,156 | 1,066,741 | 40,786 | 847,336 | 1,097,336 | 194,715 |
| 70 | 105 | 0 | 0 | 235,410 | 873,624 | 1,109,034 | 42,293 | 886,838 | 1,136,838 | 194,715 |
| 71 | 106 | 0 | 0 | 236,215 | 916,698 | 1,152,913 | 43,879 | 927,768 | 1,177,768 | 194,715 |
| 72 | 107 | 0 | 0 | 237,000 | 961,440 | 1,198,440 | 45,528 | 970,194 | 1,220,194 | 194,715 |
| 73 | 108 | 0 | 0 | 237,763 | 1,007,919 | 1,245,682 | 47,242 | 1,014,178 | 1,264,178 | 194,715 |
| 74 | 109 | 0 | 0 | 238,505 | 1,056,217 | 1,294,722 | 49,039 | 1,059,796 | 1,309,796 | 194,715 |
| 75 | 110 | 0 | 0 | 239,223 | 1,106,395 | 1,345,618 | 50,896 | 1,107,122 | 1,357,122 | 194,715 |

| Year of policy | Age | Current required premium | Policy Cash Flow | Guaranteed Policy Cash Values | Cash Value of Paid-Up Additions | Cash Surrender Value | Annual Cash Value increase | Face Amount of Paid-Up Additions | Death Benefit | Cumulative Premiums |
|---|---|---|---|---|---|---|---|---|---|---|
| 76 | 111 | 0 | 0 | 239,920 | 1,158,555 | 1,398,475 | 52,858 | 1,156,240 | 1,406,240 | 194,715 |
| 77 | 112 | 0 | 0 | 240,593 | 1,212,770 | 1,453,363 | 54,888 | 1,207,231 | 1,457,231 | 194,715 |
| 78 | 113 | 0 | 0 | 241,245 | 1,269,150 | 1,510,395 | 57,032 | 1,260,191 | 1,510,191 | 194,715 |
| 79 | 114 | 0 | 0 | 241,873 | 1,327,773 | 1,569,646 | 59,251 | 1,315,209 | 1,565,209 | 194,715 |
| 80 | 115 | 0 | 0 | 242,480 | 1,388,763 | 1,631,243 | 61,598 | 1,372,389 | 1,622,389 | 194,715 |
| 81 | 116 | 0 | 0 | 243,063 | 1,452,205 | 1,695,268 | 64,025 | 1,431,833 | 1,681,833 | 194,715 |
| 82 | 117 | 0 | 0 | 243,625 | 1,518,234 | 1,761,859 | 66,591 | 1,493,654 | 1,743,654 | 194,715 |
| 83 | 118 | 0 | 0 | 244,165 | 1,586,957 | 1,831,122 | 69,263 | 1,557,962 | 1,807,962 | 194,715 |
| 84 | 119 | 0 | 0 | 244,683 | 1,658,493 | 1,903,176 | 72,054 | 1,624,882 | 1,874,882 | 194,715 |
| 85 | 120 | 0 | 0 | 245,160 | 1,732,899 | 1,978,059 | 74,882 | 1,694,536 | 1,944,536 | 194,715 |
| 86 | 121 | 0 | 0 | 250,000 | 1,840,443 | 2,090,443 | 112,384 | 1,767,110 | 2,017,110 | 194,715 |

## Appendix B- Account Balances and Related Assets as Assets and Liabilities of the Insurer (based on criteria from the Conceptual Framework)

| Definition of Asset | Generally Satisfied? |
| --- | --- |
| An asset is a resource controlled by the entity. | ▪ The insurer legally owns the assets; policyholders do not have access or ownership of the underlying assets. When a policyholder requests a distribution, the insurer might physically redeem such assets or it might simply reallocate the assets and make a distribution in the amount of the account value. |
| An asset is a result of past events | ▪ Yes, investments are purchased by insurers once a contract is issued. |
| Future economic benefits are expected to flow to the entity (eg an asset may be used to settle a liability- Framework Paragraph 55c) | ▪ Yes, investments and investment income will be used to settle the contractual liability of death benefits, maturity guarantees and account value withdrawals. |
| **Recognition of Assets** | **Generally Satisfied?** |
| An asset is recognized in the balance sheet when:<br><br>▪ it is probable that the future economic benefits will flow to the entity and | ▪ Yes, the insurer will use the investments in the account balances to reduce its contractual liability of death benefits, maturity guarantees and withdrawals. |
| ▪ the asset has a cost or value that can be measured reliably | ▪ Value of investments can generally be measured reliably (ie always when traded on active exchange, more difficult otherwise but still estimable). |
| **Definition of Liability** | **Generally Satisfied?** |
| A liability is a present obligation. | ▪ Yes, the entity has a legally enforceable obligation to pay the policyholders according to the terms of the insurance contracts. |

| | |
|---|---|
| A liability arises from past events | ▪ Yes, obligation to pay death benefits/maturity guarantees/account withdrawals arises after the insurance contract is sold. |
| The settlement of a liability is expected to result in an outflow from the entity of resources embodying economic benefits. | ▪ Yes, investments and investment income will be returned to the policyholders in cash or other assets in which only the entity has control of. |
| **Recognition of Liabilities** | **Generally Satisfied?** |
| A liability is recognized in the balance sheet when<br>▪ it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and<br>▪ the amount at which the settlement will take place can be measured reliably | ▪ Yes, payments of investments and investment income to policyholders are in cash or other assets and will settle the insurance contract liability.<br>▪ The settlement amount can generally be measured reliably (ie using market price on active exchange or other pricing methodology). |

## Appendix C- Analysis of Tentative Unbundling Criteria Applied to Common Contracts

**Purpose:** The purpose of the accompanying chart is to illustrate the outcome of the staff's analysis of which contracts would be unbundled using the unbundling criteria tentatively decided on by the boards at the 04 May 2011 joint board meeting.

**Application of Tentative Separation Guidance to Common Insurance Contracts**

**Note:** The criteria below are based on the Boards' tentative decision at the 04 May 2011 joint board meeting to base the separation criteria off of revenue recognition.

An explicit account balance is an account balance that makes up part of the insurance contract liability that meets both of the following conditions:
EXA- The balance is an accumulation of the monetary amount of transactions between the policyholder and the insurer.
EXB- The balance is credited with an explicit return: either based on performance of specified assets or credited based on a contractual formula (whether or not the crediting rate can be periodically reset).
An insurer should account for explicit account balances as separate components of an insurance contract only if they are distinct.
1- An explicit account balance is distinct if either of the following criteria is met:
A- The insurer regularly issues separately a financial instrument with the same rights and obligations as the explicit account balance (ie it issues unit-linked / variable contracts with no insurance risk and those contracts credit returns at the same rate as the bundled contract)
B- The policyholder can benefit from the explicit account balance on its own (ie the policyholder can benefit from investment returns)
2- Notwithstanding the requirements in the preceding paragraph an explicit account balance is not distinct if the insurer's exposure to insurance risk in the combined contract is highly interrelated with its exposure to the financial risks arising from the account balance. In order to determine whether or not an account balance is highly interrelated with the remainder of the contract, an insurer should assess whether the amount of insurance risk the insurer is exposed to is significantly affected by the investment performance of the account balance.

| # | Contract Type | Today's Accounting | *Accounting Under Proposed Model* | | | | | | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| | | | | | | 1 | | | |
| **#** | **Contract Type** | **Today's Accounting** | **EXA** | **EXB** | **Result** | **A** | **B** | **2**** | **Unbundle** |
| 1 | Term life | Nothing unbundled. | NO | NO | Implicit | N/A | N/A | N/A | NO |
| 2 | Whole life | Nothing unbundled. | NO | NO | Implicit | N/A | N/A | N/A | NO |
| 3 | Deferred annuities | Premiums are generally paid by the policyholder over a specified period ("accumulation phase"), after which the insurer is obligated to pay to the holder a stream of payments as specified in the contract ("payout phase"). | See below. | | | | | | |
| 3(a) | | <u>Accumulation phase:</u> In the accumulation phase, these contracts are accounted for as investment contracts (ie payments received are reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments). | YES | YES | Explicit | NO | YES | YES* | NO |
| 3(b) | | <u>Payout Phase:</u> Accounted for as insurance contract unless the actual payout is known at inception (i.e. amount is not dependent upon the duration of the policyholder's life). | | | | | | | |

| | | | | | | | | | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 4(a) | Universal life- level death benefit**** | These account balances are unbundled under current US GAAP. | YES | YES | Explicit | NO | YES | YES | NO |
| 4(b) | Universal life- increasing death benefit**** | These account balances are unbundled under current US GAAP. | YES | YES | Explicit | NO | YES | NO | YES |
| 5(a) | Variable universal life- level death benefit**** | Account balance accounted for as investment contract under SFAS 97 (ie payments received are reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments). | YES | YES | Explicit | YES | YES | YES | NO |
| 5(b) | Variable universal life- increasing death benefit**** | Account balance accounted for as investment contract under SFAS 97 (ie payments received are reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments). | YES | YES | Explicit | YES | YES | NO | YES |

*Risks are sometimes inseparable because policyholder may have option of selecting current rate when annuitize, indicating that the account balance can affect the insurance risk. This feature is typical in the US, but not necessarily in other jurisdictions.

**Is the amount of insurance risk the insurer is exposed to significantly affected by the investment performance of the account balance?

****With a level death benefit option, the death benefit remains level throughout the policy and the insurance risk charges decrease as the insurance company deducts the policy cash value from the face amount, when setting its annual risk charge. On an increasing death benefit option, the death benefit equals the face amount plus any cash accumulation within the policy. Under this option, the risk charges remain level, but the death benefit increases each year according to the value of the investment account.