STAFF PAPER

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Project	Insurance Contracts		
Paper topic	Proposals relating to the margin for participating contracts		
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What is the purpose of this paper?

1. Some insurance contracts provide an investment return to the policyholder that is affected by the performance of underlying items (for example, a pool of specified assets or the performance of the entity). Consequently, the amount, timing or uncertainty of some of the cash flows of those insurance liabilities is affected by the performance of the underlying items. For some of these contracts there is a contractual link to specified underlying items; others do not have such a contractual link. Contracts with a contractual link to underlying items are termed 'participating contracts' and are the subject of this paper. Agenda paper 2 *Cover note: Background information and progress report* at this meeting provides a summary of the IASB's tentative decisions on participating contracts.

2. This paper considers the proposals from some preparers for adjusting and allocating the margin for participating contracts. The structure of the paper is as follows:

   (a) staff recommendation (paragraph 3);

   (b) a staff summary of the proposals from some preparers for adjusting and allocating the margin for participating contracts, termed the 'floating margin' (paragraphs 4–14); and

   (c) staff analysis of the floating margin proposals (paragraphs 15–55); and

(d) illustrative examples comparing (i) the floating residual margin approach to (ii) the IASB's tentative decisions to date, and (iii) the staff recommendations (Appendix A).

Staff recommendation

3. The staff recommend that:

   (a) the margin for participating contracts is *adjusted* for changes in the value of the premiums by adjusting the margin for changes in the value of the underlying items as measured using IFRS; and

   (b) the constraint on recognising revenue that is proposed in the Revenue recognition project should **not** be applied to the *allocation* of the residual margin for insurance contracts.

Proposals for a floating margin

4. The rationale for 'unlocking' the residual margin is to provide a more accurate depiction of the unearned profit in a portfolio of insurance contracts. Some industry groups and associations believe that, for participating contracts, the residual margin should represent the unearned profit, including the insurer's share of asset management fees and asset returns. This section sets out a staff summary of their proposals and views.

5. These industry groups and associations propose unlocking the margin for gains and losses arising from the underlying items (for example, assets, experience) when those gains and losses are not considered to be earned in the period. They describe this as a 'floating residual margin'. Typically, policyholders and the insurer share in the returns of a pool of assets over the contract duration as the service of provision of guaranteed returns is provided as bonuses at intervals over the term of the contract. Applying the industry proposal, the unearned profit would represent the difference between the cumulative level of investment returns on assets (including the insurer's share of those returns) less the cumulative level of returns allocated to the policyholders. The proponents of the floating residual margin proposal view it as a prospective measurement of the residual margin.

6. The floating residual margin proposal would not change the IASB's tentative decisions on the unlocking of the margin in the following areas:

   (a) There should **not** be a limit on the amount by which the residual margin could be increased as a result of favourable changes.

   (b) There **should** be a limit on the amount by which the residual margin could be reduced as a result of unfavourable changes. The residual margin should not be negative. Any unfavourable changes in excess of the residual margin remaining at the date of the change should be recognised immediately in profit or loss.

Performance-sharing mechanism

7. The floating residual margin proposal relies on the contract's mechanism for allocating gains arising from the underlying items between the policyholder and the insurer. Typically, the insurer formally assigns a portion of the surplus of the portfolio (ie bonuses) to the policyholder and the insurer (the insurer's share is commonly termed 'shareholders') at various times over the term of the contract. At the point the bonus is assigned, the insurer can no longer avoid paying those assigned amounts to the policyholder when the contract matures. In effect, the insurer writes a guarantee equal to the amount of the surplus assigned. In the unlikely event that the underlying items decrease in value below the guaranteed amounts to the policyholder, the insurer will have to fund that shortfall. If the policyholder surrenders early, that assigned surplus will be paid out, subject to a possible exit fee. The insurer's share of the assigned surplus represents the amounts that the insurer expects will be available for inclusion in the determination of profits available as dividends, assuming that the underlying items are able to fund the guarantees.

8. There may be an element of discretion in the performance-sharing mechanism. For example, the insurer may be able to:

   (a) change the proportions shared between the policyholder and insurer in the surpluses distributed; and/or

   (b) decide when it declares the bonuses during the contract term.

However, the level of discretion will typically be constrained by a combination of contract terms, laws or regulations. The key feature is not the discretion; instead it is the sharing of returns from the underlying items, when those returns are more certain, over the contract duration.

9. Because many participating contracts are long-term in nature, the insurer will often use the discretion available to it to vary the returns that are allocated in a given period under the performance-sharing mechanism so that it can achieve a targeted long-term return for the policyholder and, as a result, for the insurer. For example, in a period of high returns, the entity may not allocate returns if the entity believes that those returns are not sustainable in the long term. Instead, those returns may be deferred and only declared in later periods when there is more certainty surrounding cumulative asset returns.

10. For most participating contracts, the performance-sharing mechanism is significantly affected by the risks arising from the underlying items and that are shared between the policyholder and the insurer. Bonuses declared to policyholders increase the value of the guarantees in those contracts and conversely, increase the risk for the insurer (discussed in paragraph 7). Consequently, the bonuses allocated in the periods prior to maturity are likely to be done on a prudent basis and reflect the insurer's assessment of the certainty or uncertainty of the underlying items' cumulative returns. The underlying purpose is to ensure that a level of supportable bonuses (eg when the asset returns are likely to be able to meet the payment of the guarantees) is declared.

Description of different performance-sharing mechanisms

11. The following table provides a summary[1] of the different mechanisms for allocating performance according to the types of participating contracts. Further background information on the features of these contracts is in Appendix A of the October 2012 Agenda paper 2F *Overview of decisions on participating contracts*.

[1] The table has been adapted from HUB group discussion paper *Accounting for Insurance Contracts with Participating Features: Current-current through OCI with a Floating Residual Margin* dated 23 April 2012.

Description of some types of participating contracts	Types of benefits			
	Guaranteed fixed by formula	**Discretionary** determined and paid at the discretion of the entity	**Terminal** determined and paid when the contract terminates	**Unit-linked** benefit linked to unit prices of an investment fund
Discretionary 90/10 The policyholder is legally or contractually entitled to receive at least 90% of the (post-tax) statutory result of the business. The insurer usually decides to pay more than the 90%. The actual amount to be paid is unknown until declared each year by the insurer.	✓	✓		
Fixed 90/10 The insurer is only entitled to receive 10% of earnings on the business. All other earnings must be paid to policyholders. However, dividends are not necessarily paid in the year earned.	✓			
With profits The returns on the underlying items are typically volatile; consequently, a large proportion of the returns are distributed at the end. The annual bonus (ie regular or reversionary bonus) is often small, reflecting the uncertainty in the sustainability of current returns. Bonuses are declared when deemed supportable/certain. The insurer may choose not to declare annual bonuses if returns are unsustainable. The final bonus (ie terminal bonus) is calculated when the policy matures, or is surrendered close to maturity, and is determined so that the policyholders get their fair share of the returns. The insurer's share in the distribution of surpluses is in direct proportion to the provision of the guaranteed bonuses over the duration of the contract.	✓		✓	
No guaranteed participation rate Participation is not typically guaranteed. Dividends are determined annually by the board of directors. There may not be a fixed spread or other element that determines the amount paid. Terminal bonuses are often paid but are not generally important.		✓		
Variable/Unit-linked A contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund (ie a specified pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund).				✓

Explaining the mechanics of the proposals

13. The following simplified example illustrates the proposal to adjust the margin for gains and losses arising from the underlying items (for example, assets, experience) to which the participating contract is linked, when those gains and losses are potentially attributable to the insurer in the period. The assumptions are simplified to illustrate how the gains or losses potentially attributable to the insurer would adjust the margin.

Example 1: Floating margin proposal

A portfolio of participating contracts was written at the beginning of the year[2]:

- received premiums totalled CU1,000[3], which was used to purchase assets;
- policyholder participates in 90% and the insurer in 10% of the asset returns; and
- the expected present value of the cash outflows is CU900 and the margin is CU100.

At the end of the year:

- management declares a bonus of CU90 to the policyholders and CU4 represents the insurer's share (total bonuses declared are CU94); and [4,5]
- the underlying assets have grown to CU1,100 (an increase of CU100).

Under the boards' mirroring decisions, the insurance liability would be increased by CU90 (90% X 100[increase in the value of the assets]).

Under the industry's proposal:

- gains potentially attributable to the insurer of CU10 (CU100[Investment income]–CU90[Policyholder's share in investment income)) would be adjusted against the residual margin; and

[2] This is a simplified example of a Discretionary 90/10 style participating contract.

[3] In this Staff Paper, currency units are denominated in "currency units" (CU).

[4] For some contracts, the bonuses declared are typically unrelated, or only incidentally related, to the short-term fluctuations in asset returns arising in the reporting period.

[5] For some contracts, the performance-sharing mechanism would determine the ratio of insurer to policyholder bonuses.

- CU4 would be released from the margin, representing the insurer's share in the bonus declared.
- As a consequence, net profit considering both the underlying items and the liability is CU4, which represents the insurer's share in the bonus declared.

The profit or loss for the period would be as follows (ignoring the accretion of interest on the residual margin):

	CU
Investment income	100
Interest expense (change in the expected cash outflows)	(90)
Remeasurement of the margin	(10)
Release of the residual margin (insurer's share of bonuses declared)	4
Net profit	**4**

At the end of the period the liability would have increased by a net amount of CU96, which comprises the policyholder's share of CU90 and the net gain potentially attributable to the insurer in future periods of CU6 (net adjustment of the margin).

Rationale behind the proposal

14. Those who propose adjusting gains or losses potentially attributable to the insurer against the margin argue that:

    (a) their proposal is consistent with the measurement of the rest of the building block approach, because the residual margin would be measured on a current basis.

    (b) adjusting the margin for those gains or losses is consistent with the IASB's reasons for recognising a margin on day one—that the gain has yet to be earned. Just as the profit arising from the amount charged to the policyholder has yet to be earned, so too has the profit from changes in the value of underlying items. Their proposal would only recognise net gains that arise from increases in value in the underlying assets when there is reasonable certainty that they are earned. They argue that

those gains are only earned when the bonuses are declared—when the insurer thinks the asset returns are sustainable in the long term (ie, when it becomes reasonably assured). They believe that because these contracts are long-term in nature, the pattern of profit recognition would be consistent with the economics of the transaction.

(c) their proposals are consistent with the application of the IASB's proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers* to revenue contracts for asset management services. That ED would constrain the amount of revenue recognised to amounts that are 'reasonably assured'. They believe that the insurer's interest in the underlying items is similar to an 'asset management fee'. Consequently, the pattern of profit recognition for the contracts should be similar to revenue contracts for asset management services which have broadly similar economic features. All other things being equal, the profit recognition pattern on a contract where the insurer receives an asset management fee should be the same as one in which the insurer receives an identical amount through a combination of lower fees with a share of returns on an asset pool.

Staff analysis

15. In effect, the floating margin proposal treats:

(a) the insurer's share of investment income or losses arising from the underlying items as an adjustment to the value of the cash inflows of the contract (ie the premiums) implicit in the margin. (In Example 1, the gain of CU10 potentially attributable to the insurer is treated as an adjustment to the margin.) Paragraphs 16-29 discuss this.

(b) the insurer's share in declared bonuses as the driver for the release of the residual margin. The bonuses declared are a proxy for the value of the services provided to the policyholder in the period. (In Example 1, the release of the residual margin is decided upon to achieve a net profit recognised equal to the CU4 that is the insurer's share in the bonus.) Paragraphs 30-55 discuss this.

While the following paragraphs discuss these two proposed treatments in turn, those who support the floating residual margin hold the view that these two proposals are integral to their view of the residual margin representing the unearned profit of those contracts.

Updating the value of the premiums

Background on the IASB's view of the residual margin

16. The IASB's thinking underpinning its proposals for the residual margin is that the margin represents the unearned profit in the contract, both at inception and subsequently. Consistently with this view, the IASB has made the following tentative decisions:

    (a) At inception, the margin is determined as the expected premiums to be received in the contract less the expected present value of cash outflows (both adjusted to reflect risk and uncertainty).

    (b) After inception,

        (i) the margin is adjusted (ie 'unlocked'), which provides a more up-to-date estimate of the profitability of the contract; and

        (ii) interest is accreted on the margin, which reflects the time value of the services implicit in the margin.

17. Agenda paper 2A *Unlocking the residual margin* recommends that the residual margin should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services. This would mean that:

    (a) for fees, the residual margin would be unlocked only for changes in the estimates of the future management fee; and

    (b) for changes in asset returns, the residual margin would be unlocked for any change in the expected amount retained by the insurer; for example, as a result of a change in the proportions of asset returns shared between the policyholders and the insurer.

Is the floating residual margin consistent with the IASB's views?

18. Those who proposed the floating residual margin approach characterised their approach as an adjustment to the margin (ie 'unlocking') (paragraph 16(b)(i)). However, the staff think that a better way to characterise their approach is that it is remeasuring the carrying amount of the unearned profit for the provision of services as represented in the margin.

19. Under the IASB's tentative decisions, the margin is adjusted for the effects of the time value of money by accreting interest on the margin using the discount rate at inception. Other reasons for accreting interest on the margin are that it:

    (a) is consistent with the other components of the insurance liability and with how the margin is estimated at inception; and

    (b) reflects the implicit financing in the premiums received or receivable.

20. As a result, the IASB's decision to accrete interest on the margin remeasures the value of the premium that was used to determine the margin. Another alternative to updating the value of the premium used to determine the margin would be to estimate the amount of premiums that would have been charged each period had the insurer written that contract in that period. This would be difficult and costly for many insurance contracts. However, for participating contracts, in which there is a contractual link between the contract and underlying items, the value of the linked items could serve as a proxy for the updated value of the premiums.

21. Consequently, the staff view the floating residual margin approach as akin to remeasuring the premiums used to determine the margin, by treating the value of the linked items as a proxy for the updated value of the premiums. Under the IASB's tentative decisions, when the value of the linked items change, the policyholder's share in those values results in a change in the estimate of the liability's cash outflows and in the value of the options and guarantees.

Illustrating how the floating margin approach remeasures the margin

22. In Example 1, the investment income of CU10 above the amounts that represent future outflows to the policyholder is treated as an increase in the value of the premiums received. Using the same simplified facts as Example 1, the following

explains how the gain of CU10 that is potentially attributable to the insurer can be viewed as an increase in the value of the premiums received:

Example 2: The effect of adjusting the margin by the gains and losses potentially attributable to the insurer

A portfolio of participating contracts was written at the beginning of the year:

- premiums totalled CU1,000, which was used to purchase assets; and
- the policyholder participates in 90% and the insurer 10% of the asset returns.

Thus, the policyholder exchanges 100% of the assets worth CU1,000 for a promise to receive 90% of the future value of the assets, plus the services provided by the contract.

- the present value of cash outflows is CU900. Consequently, the margin at the inception of the contract is CU100.

	Start of the contract	**End of the year**
Value of the assets	1,000	1,100

The floating margin uses 100% of the linked assets as a proxy of the value of the premiums after inception. Consequently, if the policyholder were to purchase the same contract at the end of the year:

- 100% of the underlying assets are used as a proxy for the premiums it would pay if the contract had been purchased at the end of the year. Consequently, the premiums are assumed to be CU1,100 (100% of the value of the assets of CU1,100).
- The present value of the cash outflows, under the mirroring approach, would be CU990 (90% of the value of the assets of CU1,100 or CU900+CU90).
- Accordingly, the total estimated margin is CU110 (CU1,100–CU990) before any allocation for the services provided. This is an increase of CU10 compared to the margin calculated at inception. Consequently, the margin is remeasured by increasing it by CU10.

An example with a guarantee

23. Most, if not all, participating contracts have more features (eg options and guarantees) than the contract used in the example. However, the same logic can be applied to contracts with those additional features. On day 1, the premiums

paid equal the value of 100% of the assets. The policyholder exchanges 100% of the assets for (1) a future obligation to return 90% of those asset returns; (2) guarantees and options; and (3) the provision of insurance coverage, asset management services and other services—represented in the margin. Consequently, after inception, 100% of the assets can be used as a proxy for the value of the premiums. The adjustment of the margin to reflect the change in the value of the premiums can be calculated as 100% of the asset returns minus both the changes in the value of the cash outflows and the changes in the values of the guarantee and options. Example 3 illustrates this.

Example 3: Participating contracts with a guarantee

A portfolio of participating contracts was written at the beginning of the year:

- premiums totalled CU1000, which was used to purchase assets;
- the policyholder participates in 90% and the insurer 10% of the asset returns; and
- there is a minimum interest guarantee.

Thus, the policyholder exchanges 100% of the assets worth CU1,000 for a promise to receive 90% of the future value of the assets with a minimum interest guarantee, plus the services provided by the contract.

- The present value of cash outflows is CU900 and the value of the guarantee is CU8. Consequently, the margin at the inception of the contract is CU92 (CU1000-CU900-CU8).

	Start of the contract	**End of the year**
Value of the assets	1000	1100

The floating margin uses 100% of the linked items as a proxy for the value of the premiums after inception. Consequently, if the policyholder were to purchase the same contract at the end of the year:

- 100% of the underlying assets are used as a proxy for the premiums it would pay if the contract had been purchased at the end of the year. Consequently, the premiums are assumed to be CU1,100 (100% of the value of the assets of CU1,100).
- The present value of the cash outflows, under the mirroring approach, would be CU990 (CU900+CU90 or 90% X 1,100[the value of the assets])
- The value of the guarantee using a market-consistent valuation is CU7 (the change in value of the guarantee is a gain of CU1 [CU8-CU7]).

Consequently, the total estimated margin is CU103 (CU1100–CU990–CU7) before any allocation for the services provided. This is an increase of CU11 compared to the margin calculated at inception.

Under this industry's proposal:

- gains potentially attributable to the insurer of CU11 would be adjusted against the residual margin; and
- CU4 would be released from the margin, representing the insurer's share in the bonus declared. Management declares a bonus of CU90 to the policyholders and CU4 to the insurer.

The profit or loss for the period would be as follows (ignoring the accretion of interest on the residual margin):

	CU
Investment income	100
Interest expense	(90)
Change in the value of the guarantee	1
Remeasurement of the margin	(11)
Release of the residual margin (insurer's share of bonuses declared)	4
Net profit	**4**

24. The floating margin proposal effectively treats the change in the value of the guarantees and options as an adjustment of the margin. Example 3 illustrates that this is consistent with how the margin is estimated on day 1. In addition, it is consistent with the idea the options and guarantees, services, and insurance coverage are interrelated and therefore, the margin represents the unearned profit from the entire contract and the rationale behind remeasuring the margin. So that the measurement of the margin is consistent at inception and afterwards.

Comparing the floating residual margin to the accretion of interest on the margin

25. The differences and similarities between the floating residual margin approach and the IASB's current tentative decisions on accreting interest on the margin are:

(a) the floating residual margin approach reflects the changes in the value of the premium that would have been charged at the reporting date by

reference to the change in the value of the linked items. Under the IASB's tentative decisions, the change in the value of the premiums is reflected by accreting interest on the carrying value of the margin using the discount rate at inception. This calibrates the margin to the premiums charged.

(b) the floating residual margin approach remeasures the margin by reference to the current value of the premiums. Accreting interest on the margin reflects the time value of those premiums. This is the case even when the underlying assets are measured at cost if the duration of those assets is likely to be shorter than the liability. Consequently, when those assets are reinvested, the locked-in interest rate is reset to the current discount rate. Because the IASB has chosen to accrete using the discount rate at inception, accreting reflects the time value assumptions used in the pricing of the contract. Applying the IASB's tentative decisions the discount rate at inception would not be reset to the current discount rate for the purposes of accreting interest on the residual margin.

(c) the IASB's view is that the margin is part of the insurance liability. Consequently, when the margin is measured inconsistently from the rest of the cash flows, an accounting mismatch may arise. This is likely to occur (1) when the margin is accreted using the discount rate at inception and (2) when the underlying items are measured at fair value and hence, the expected cash flows are measured at a current value. Because the floating residual margin uses the underlying items measured in accordance with IFRS as a proxy for the value of the premiums, this approach would reduce that accounting mismatch.

(d) Under the floating residual margin approach, if the linked items are accounted for at fair value, adjusting the value of the premiums in the margin can result in either an increase or decrease of the carrying value of the margin. However, the residual margin can never be less than zero. Accreting interest on the margin increases the carrying value of the margin.

(e) There is no difference between the floating residual margin proposals and the IASB's tentative decisions when the margin is zero.

Appendix A provides illustrative examples comparing the floating residual margin approach to the IASB's tentative decisions to date, including the accretion of interest, and the staff recommendations.

26. The staff thinks that adjusting the margin in this way to reflect changes in the value of the premium that would have been charged at the reporting date is consistent:

(a) with the IASB's rationale underlying the accretion of interest on the margin; and

(b) with the depiction of the residual margin as an updated measure of the unearned profit in the contract, with one significant benefit—the reduction of accounting mismatch that may arise from accreting at the discount rate at inception. One of the reasons the IASB decided on the mirroring approach for participating contracts is to address accounting mismatch.

27. Adapting the floating margin approach to be consistent with IASB's mirroring approach would result in the following:

(a) If the underlying assets are measured at fair value through profit or loss, the changes in fair value of the assets potentially attributable to the insurer adjusts the margin.

(b) If the underlying assets are financial assets measured at fair value through OCI, interest income presented in profit or loss, and the gains or losses in OCI, potentially attributable to the insurer adjust the margin.

(c) If the underlying assets are financial assets measured at amortised cost, the interest income in profit or loss potentially attributable to the insurer adjusts the margin.

28. Consequently, instead of accreting the margin of participating contracts using the discount rate at inception, the staff recommends adjusting the margin by the gains

or losses arising from the changes in the value of the underlying items potentially attributable to the insurer.

29. The staff acknowledge that adjusting the margin in this way increases complexity in the proposed model, because different requirements apply to the margin depending on whether the contract is participating or non-participating. However, because participating contracts are contractually linked with those underlying items, this approach does not significantly increase the cost of applying this approach. The staff notes that as a result of its recommendation, both the residual margin in participating and non-participating contracts would reflect the changes in the value of the premiums:

    (a) for participating contracts, because there is a contractual linkage with the assets, this can be done by a reference to those assets.

    (b) for non-participating contracts, the simpler alternative of accreting the carrying value is used, because those contracts have no contractual linkage to assets.

Question 1—Adjusting the margin to reflect the change in the value of the premiums for participating contracts
Does the IASB agree to adjust the margin for participating contracts for changes in the value of the premiums by adjusting the margin for the change in value of the underlying items as measured using IFRS?

Allocation of the margin

30. The following paragraphs:

    (a) describe the IASB's previous decisions on the allocation of the margin (paragraphs 31-34);

    (b) set out the industry's proposal on the allocation of the margin (paragraphs 35-38); and

    (c) provide the staff's analysis and recommendation (paragraphs 39-55).

Background to the IASB's decisions on the allocation of the margin

31. The ED proposed that the insurer should recognise the margin in a systematic way that best reflects the exposure from providing insurance coverage, and specified that this should be on the basis of the passage of time, unless the pattern of the expected timing of incurred claims and benefits differs significantly from the passage of time. In that case, the margin would be allocated on the basis of the expected timing of incurred claims and benefits.

32. However, different contract types will provide different services in different patterns. The comment letters on the Exposure Draft indicated that the IASB's assumptions about the drivers of service provision were too restrictive. As a result, to specify the allocation of the margin in a principle-based way, the IASB decided:

    (a) that the insurer should allocate the residual margin in a pattern consistent with the pattern of transfer of the services provided; and

    (b) to delete the Exposure Draft's requirement that the allocation should be based on the passage of time or on the timing of incurred claims and benefits.

33. The proposed pattern of allocation is consistent with the view that the residual margin represents the expected profit from the services provided by an insurance contract other than for bearing risk, and that this expected profit should be recognised in profit or loss as the insurer performs those services. The insurer would be required to determine one, or more than one, driver that best reflects the pattern of transfer of those services and then allocate the residual margin over the coverage period. Because the margin is a blend of the various services that are not separately identifiable, any release pattern is inevitably arbitrary to some extent.

34. Participating contracts are predominantly investment contracts. Those contracts oblige the insurer to provide asset management services in addition to insurance coverage, and the IASB's tentative decisions on unbundling goods and services mean that not all these services would be unbundled (eg if they are integrated with the insurance coverage). For such contracts, a profit driver based on assets under management may be appropriate, because the principal service provided is

investment management. For these contracts, previous agenda papers stated that a reasonable pattern for the profit would be one that tracks the build-up of the assets over time.

Industry's proposal

35. Under the floating margin proposal, the profit driver for the allocation of the residual margin would be consistent with the performance-sharing mechanism between the policyholder and insurer. Those promoting the floating margin proposal believe that the insurer's share of the bonuses declared represent the earned profit from providing services under the contract. As discussed in paragraphs 7-12, the profit sharing mechanisms between policyholders and insurer, in general, are:

    (a) meant to reflect the risk shared by both parties;

    (b) capable of increasing the value of the guarantees; and

    (c) are constrained by regulation or competitive forces, or both, to differing extents.

36. Applying the performance-sharing mechanism as the profit driver, some preparers have proposed two variations of determining the amount of the residual margin to be allocated in the period that result in the carrying value of the margin representing the value of future bonuses to the insurer. Assuming no guarantees and options, the two variations explained are:

    (a) **Variation 1**: the total net profit recognised from the changes in the underlying assets and the insurance liability, including the margin, equals the bonus declared to the insurer in that period. This method is consistent with an approach currently used in some jurisdictions. (In Example 1, the amount of the margin allocated in profit or loss of CU4 is determined so that the net profit or loss of the period equals the insurer's share in the bonus declared.) The outcome of this approach is that the carrying value of the residual margin represents the value of future bonuses that are yet to be paid out; or

    (b) **Variation 2**: the carrying value of the residual margin at the end of the period is decided upon directly by calculating the present value of the

insurer's share of future bonuses. Consequently, the allocation of the margin is the amount needed to adjust the margin so that its carrying value equals the directly determined present value of insurer's share of future bonuses.

37. If there are guarantees and options, Variations 1 and 2 are modified so that the sum of the carrying amount of the margin at the end of the period and the value of the options and guarantees is assumed to equal the present value of the insurer's share of future bonuses.

38. Those that promote the methods described in paragraph 36 argue that those methods allow the insurer to recognise in each period the net profit or loss arising from the provision of the services provided by participating contracts. In addition, they believe that their proposals are consistent with the Revenue recognition proposals, which would constrain the amount of revenue (and hence profit) recognised to amounts that are 'reasonably assured'.

Staff analysis

39. The following paragraphs provide the staff's analysis of the industry proposals for participating contracts, by considering:

    (a) whether using the performance-sharing mechanism as the profit driver for the allocation of the residual margin is consistent with the IASB's previous tentative decisions and, if not, whether the IASB should amend those decisions (paragraphs 40-43); and

    (b) how the Revenue recognition proposal on constraining the amount of revenue recognised would be applied to participating contracts and whether such a constraint is necessary (paragraphs 44-54).

    The staff recommendation is provided in paragraph 55.

Should the IASB require that the profit driver for the allocation of the residual margin is the performance-sharing mechanism?

40. As discussed in paragraphs 7-12, there are various factors that influence the performance-sharing mechanism of participating contracts.[6]

41. For some participating contracts, the performance-sharing mechanism may be an appropriate driver for allocating the margin. For example, this might be the case when the policyholder shares in the realised returns of the linked assets and the bonuses are declared when those returns are realised. However, for other participating contracts, the performance-sharing mechanism may not be indicative of the pattern of services provided. This may be the case when:

    (a) the bonuses are highly regulated or the bonuses are declared on a prudent basis and hence, the bonuses may not be declared in a way that reflects the services provided by the contract; and

    (b) the major distribution of the asset returns occurs on maturity of the contract. This would result in a greater allocation of the margin at the end of the contract, even though the policyholder benefits from the asset management and insurance services throughout the life of the contract.

42. In those cases, the preparers argue that the bonus declaration mechanism is consistent with the constraining revenue proposals to amounts 'reasonably assured' in the Revenue recognition project. The staff observe that if the revenue recognition proposals were applied to these contracts, in many cases an insurer would not allocate any residual margin to profit and loss until the insurance contract's termination/maturity (This is discussed further in paragraphs 44-47).

43. The staff think that a reasonable pattern for the allocation of the margin:

    (a) views the provision of services (eg the asset management services and insurance coverage) as satisfied over the life of the contract;

[6] If the bonus is declared according to the expected performance-sharing ratio between the policyholder and insurer, no revisions to the expected cash outflows are needed under the IASB's tentative measurement model. Under the IASB's tentative decisions, the measurement of the liability should include all such payments that result from that contract, whether paid to current or future policyholders. However, the value of the options and guarantees is likely to change if the bonus declared affects their value.

(b) is based on the insurer's expectations of total unearned profit and allocates that unearned profit in a reasonable, systematic way (for example, the build-up of the underlying assets); and

(c) if the bonuses are allocated in the same pattern as the estimate of the provision of services, the pattern of bonuses may be an acceptable proxy for the provision of services under those contracts. As discussed in paragraph 41, some performance-sharing mechanism may not be predictive of the provision of services provided.

The Revenue recognition proposal on constraining the amounts of revenue recognised

44. The boards' 2011 Exposure Draft *Revenue from Contracts with Customers* ('the 2011 ED') proposed a constraint on the cumulative amount of revenue recognised that would apply if the amount of consideration to which an entity expects to be entitled is variable ('the constraint'). The constraint was proposed in paragraphs 81–85 of the 2011 ED. Revenue is constrained to the amount to which the entity is reasonably assured to be entitled. A criterion that the entity is reasonably assured to be entitled is the entity's experience (or other evidence) that is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

45. Indicators of where the entity's experience is not predictive are in paragraph 82 of the 2011 Exposure Draft, which is reproduced below (italics added):

> 82 Indicators that an entity's experience (or other evidence) is not predictive of the amount of consideration to which the entity will be entitled include, but are not limited to, the following:
>
> *(a) the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgement of third parties, weather conditions and a high risk of obsolescence of the promised good or service.*
>
> *(b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.*

> (c) the entity's experience (or other evidence) with similar types of performance obligations is limited.
>
> *(d) the contract has a large number and broad range of possible consideration amounts.*

46. We have highlighted in italics above the three indicators that most insurance contracts, including participating contracts, are likely to meet. Therefore we think that, if the Revenue recognition guidance on constraining the amount of revenue recognised were to be applied to the allocation of the residual margin, most, if not all, insurance contracts with variable consideration would release the margin only on termination/maturity of the contract.

47. At the November 2012 joint meeting, the boards have tentatively decided that the objective of the constraint is for an entity to recognise revenue at an amount that should not be subject to significant revenue reversals (that is, to any downward adjustment) that might arise from subsequent changes in the estimate of the amount of variable consideration to which the entity is entitled. The indicators in paragraph 82 of the 2011 Exposure Draft are retained. Staff think the discussion in paragraphs 44-46 would still apply under the boards' recent tentative decisions on the constraint.

48. While consistency with the Revenue recognition proposals is ideal, sometimes this is not possible because of the different objectives and the scopes of those projects. This is reflected in the decision of the IASB to develop a Standard for the accounting for insurance contracts, rather than including such contracts within the scope of the Revenue recognition proposals.

49. The reasons for that decision were set out in the Basis for Conclusions from the ED explaining why the IASB decided to have a separate project on Insurance contracts and are relevant in explaining why the release of the residual margin should not be constrained in the same way that the revenue recognised would be constrained if applying the guidance developed in the Revenue recognition project:

> BC30 A further problem arises because the revenue recognition model applies different approaches to contract rights and unsatisfied performance obligations, by measuring:

> (a) the contract rights on an expected present value basis.
>
> (b) the unsatisfied performance obligations at the amount of consideration allocated to those obligations, supplemented by an onerous contract test based on future cash flows.
>
> BC31 Applying different approaches to contract rights and performance obligations amounts to an implicit assumption that the contract generates two separate streams of cash flows that are independent of each other. However, that is not the case for many insurance contracts. As an example, consider a 20year life insurance contract with monthly premiums. If the contract lapses because the policyholder does not pay the premium for month 60, the insurer will not pay death benefits if the policyholder dies in month 61 or after. Similarly, if the policyholder dies in month 35, the insurer will not receive premiums for month 36 or after. Accounting for the inflows separately from the outflows would not represent their nature faithfully because it would imply that the inflows and outflows do not affect each other. In contrast, the approach proposed in the draft IFRS treats all inflows and outflows in the same manner.

50. Under the building block approach, the contract rights and the unsatisfied performance obligations are both measured on an expected present value basis, which determines the margin. In contrast to the Revenue recognition proposals is a customer consideration model that measures the unsatisfied performance obligations as the same amount as the rights in the contracts (ie the unsatisfied performance obligations are not measured explicitly). The Revenue recognition proposals relating to the 'reasonably assured' criteria apply to the satisfied performance obligations.

51. The staff think that it would be inconsistent to recognise profit on a 'reasonably assured' basis when the measurement of the unearned profit (ie the margin) is determined using an expected present value basis. To maintain a coherent measurement basis, both the unearned profit and the amount of profit released to profit and loss each period must be on a consistent basis. If the unearned profit,

which is measured on an expected present value basis, is released using profits determined on a 'reasonably assured' basis, then the measurement basis would no longer be on an expected present value basis.

52. Because the building block approach is a current measurement model and the residual margin depicts a current view of future profits, a better analogy for the recognition pattern of profit would be to other IFRSs that use a current measurement model, such as assets or liabilities measured at fair value. Gains arising on financial assets or liabilities at fair value are not subject to the constraints proposed by Revenue recognition, even though fair value gains may reverse in future periods. For assets or liabilities measured at current value through profit or loss, the IASB believes that fair value gains or losses that occur in the period provide useful information.

53. Another argument in favour of not constraining the profit recognised to amounts that are reasonably assured is that the IASB has chosen to recognise gains that arise as a result of changes in the risk adjustment in profit or loss, even though those gains may reverse in a future period. The IASB did so because it believes that this provides important information on the changes of the risk borne by the entity. If the IASB were to constrain the allocation of the residual margin using the Revenue recognition proposals, that would lead to an inconsistency in the recognition of changes on the risk adjustment.

54. Consequently, the staff believe that the allocation of the residual margin should **not** be subject to the same constraints as proposed in Revenue recognition, because this would result in recognising all of the residual margin when the contract terminates. This does not reflect the pattern of services provided for the majority, if not all, of insurance contracts, including participating contracts.

Staff recommendations

55. The staff recommends that the IASB should confirm the present decisions:

(a) that the allocation of the margin for participating contracts is according to the services provided; and

(b) not to apply the Revenue recognition guidance on constraints to the allocation of the residual margin for all insurance contracts

If necessary, application guidance could be developed on the appropriate pattern of allocating the margin based on the discussion in paragraph 43.

Question 2—Allocating the margin for participating contracts
Does the IASB agree that the constraint on recognising revenue proposed in the Revenue recognition project shall **not** be applied to the allocation of the residual margin for insurance contracts?

Appendix A: Contrasting the floating residual margin proposals with the current IASB decisions and staff recommendation

A1. The following example uses the same facts as the simplified Examples 1 and 2. Those facts are repeated for convenience. Example 4 contrasts the profit or loss applying the floating margin proposal, the IASB's tentative decisions up to this point and staff's recommendations.

Example 4: Contract with no guarantee

A portfolio of participating contracts was written at the beginning of the year[7]:

- received premiums totalled CU1,000, which was used to purchase assets;
- policyholder participates in 90% and the insurer in 10% of the asset returns; and
- the present value of the cash outflows is CU900 and the margin is CU100.

For simplicity, there are no guarantees or options.

At the end of the year:

- management declares a bonus of CU90 to the policyholders and CU4 represents the insurer's share. [8,9]
- the underlying assets have grown to CU1,100 (an increase of CU100)

Under the boards' mirroring decisions, the insurance liability would be increased by CU90. Interest is accreted on the margin at 5% and therefore by CU5 (5% X100). The residual margin allocated according to the services provided is CU3.

The profit or loss for the period would be as follows:

[7] This is a simplified example of a Discretionary 90/10 style participating contract.

[8] For some contracts, the bonuses declared are typically unrelated, or only incidentally related, to the short-term fluctuations in asset returns arising in the reporting period.

[9] For some contracts, the performance-sharing mechanism would determine the ratio of insurer to policyholder bonuses.

	Floating margin	**IASB's margin**	**Staff's rec**[10]
	CU	CU	CU
Investment income	100	100	100
Interest expense (expected cash outflows)	(90)	(90)	(90)
Interest expense (accretion of the margin)	-	(5)	-
Remeasurement of the margin	(10)	-	(10)
Release of the margin	4	3	3
Net profit	4	8	3

A2. In Example 4, the net profit reported under the IASB's tentative decisions would consist of the insurer's potential share of 10% share of the investment income minus the interest accreted and the amount of the margin release according to the services provided. Under the floating residual margin proposal, the net profit is the amount released from the margin that is the insurer's share of the bonuses declared. Under the staff's recommendation, the net profit is the allocation of the residual margin according to the services provided.

A3. Using the same facts as in Example 3, the following is an illustration of the IASB's current decisions up to this point and the floating margin when the participating contract contains options and guarantees.

Example 5: Contract with a guarantee

A portfolio of participating contracts was written at the beginning of the year:

- premiums totalled CU1,000, which was used to purchase assets;
- the policyholder participates in 90% and the insurer 10% of the asset returns; and
- there is a minimum interest guarantee.
- The present value of cash outflows is CU900 and the value of the guarantee is CU8. Consequently, the margin at the inception of the contract is CU92 (CU1,000-CU900-CU8).

[10] Staff rec=Staff's recommendation in this paper.

At the end of the year:

- management declares a bonus of CU90 to the policyholders and CU4 represents the insurer's share.
- The underlying assets have grown to CU1,100 (an increase of CU100).
- The value of the guarantee using a market-consistent valuation is CU7. The change in value of the guarantee is a gain of CU1

Under the boards' mirroring decisions, the insurance liability would be increased by CU90. Interest is accreted on the margin at 5% and therefore by CU5 (5% X 92). The residual margin allocated according to the services provided is CU3.

The profit or loss for the period would be as follows:

	Floating margin	**IASB's margin**	**Staff rec**
	CU	CU	CU
Investment income	100	100	100
Interest expense (expected cash outflows)	(90)	(90)	(90)
Interest expense (accretion of the margin)	-	(5)	-
Change in value of the guarantee	1	1	1
Remeasurement of the margin	(11)	-	(11)
Release of the margin	4	3	3
Net profit	4	9	3

A4. In Example 5, the net profit reported under the IASB's tentative decisions would consist of:

(a) the potential insurer's share of 10% share of the investment income;

(b) increased by the gain from the change in the value of the guarantee;

(c) minus the interest accreted; and

(d) increased by the amount of the margin release according to the services provided.

Under the floating residual margin proposal, the net profit is the amount released from the margin that is the insurer's share of the bonuses declared. Under the staff's recommendation, the net profit is the allocation of the residual margin according to the services provided.