

STAFF PAPER

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Project	Insurance contracts		
Paper topic	Overview of decisions on participating contracts		
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What is this paper about

1. The purpose of this paper is to:
 - (a) Summarise the tentative decisions made to date for contracts with participating features;
 - (b) Illustrate how those decisions interact with the decision to present the effect of changes in discount rates in other comprehensive income (OCI).
 - (c) Ask the FASB how changes in the insurance liability arising from changes in discount rate should be presented in comprehensive income for participating contracts where the mirroring decisions do not apply.
2. This paper does not discuss how the decision to unlock the residual margin for changes in expected future cash flows would affect participating contracts. This will be discussed at a future meeting.
3. This paper is structured as followed:
 - (a) Background – a description of the features of participating contracts (paragraphs 4 - 6);
 - (b) Summary of the decisions made to date for participating contracts (paragraphs 7 - 9);

- (c) Illustrations of how a number of simple participating contracts would be accounted for under the proposed approach including a discussion of how the decision to present the effect of changes in discount rates in OCI would affect participating contracts (paragraphs 10 - 38);
- (d) FASB only – a discussion of how changes in the insurance liability arising from changes in discount rate should be presented in comprehensive income for participating contracts to which the mirroring decisions do not apply (paragraphs 39 - 43)¹.

Background

- 4. This paper considers insurance contracts that provide policyholders with the contractual right to share in:
 - (a) the performance of a specified pool of insurance contracts;
 - (b) the performance of a specified pool of assets; or
 - (c) the profit or loss of the entity that issues the contract².

In this paper, we refer to contracts of this type as ‘participating contracts’.

- 5. The types of participating contracts vary both within jurisdictions and between jurisdictions. However, all contracts considered in this paper include the following features:
 - (a) The (individual) policyholder transfers insurance risk to the insurer or to a pool in exchange for a premium, and thus receives insurance protection.

¹ This section is not relevant to the IASB because the IASB has decided that mirroring should apply to all participating contracts.

² This paper does not consider contracts that adjust cash flows based on the loss experience of the individual contract: eg retrospective rate adjustment or experience based refunds (ie the premium is reset), mandatory reinstatement premium in reinsurance (which is akin to the policyholder keeping a larger share of the loss). Cash flows arising from such contractual features would be treated in the same way as the other cash flows arising from the contract.

- (b) The insurance risk and the investment risk on the assets purchased with the premium are managed together.
 - (c) The overall performance of the pool or insurer is shared with the community of policyholders. The insurer may have discretion over the amount and timing of cash flows that result from the participation feature. Consequently, the performance of the pool or the insurer in one period may be shared with policyholders in subsequent periods or may even be shared with different generations of policyholders.
 - (d) The insurer includes in its financial statements the underlying assets and liabilities on which the participation is based.
6. Appendix A to this paper provides additional background information on participating contracts including a description of common contract types. It is reproduced from Agenda Paper 3F/FASB memo 60F of the March 2011 Joint Board meeting.

Summary of decisions

7. All tentative decisions of the boards equally apply to participating contracts. However, three tentative decisions are of particular relevance to participating contracts (appendix B provides a summary of the decisions):
- (a) The ‘mirroring approach’ for participating insurance contracts. Under this approach, in order to avoid accounting mismatches, the insurer measures and presents the part of the obligation that relates to the underlying items on the same basis as it measures and presents those underlying items. To achieve this overall objective, the boards tentatively decided the following:
 - (i) The IASB tentatively decided that the measurement of the fulfilment cash flows relating to the policyholder’s participation should be based on the measurement in the IFRS financial statements of the underlying items in which the policyholder participates. An insurer should present changes in the insurance contract liability in the statement

of comprehensive income consistently with the presentation of changes in the linked item.

(ii) The FASB tentatively decided that the obligation due to the performance-linked participating features should be measured based on an insurer's contractual obligation incurred to date adjusted to eliminate accounting mismatches that reflect timing differences between the contractual obligation and the measurement of the underlying items in the U.S. GAAP statement of financial position that are expected to reverse within the boundary of the insurance contract. Any changes in the liability for performance-linked participation features should be presented in the same way in the statement of comprehensive income as the changes in the underlying item. Appendix C describes this approach in more detail.

(b) The tentative decision that the discount rate for cash flows arising from a participating contract should reflect the dependence of those cash flows on the performance of those assets, if any, that affect the amount, timing or uncertainty of those cash flows. This decision achieves consistency between the characteristics of those cash flows (ie their amount, timing and uncertainty) and the discount rate for those cash flows.

(c) The tentative decision to include in the measurement of the insurance liability contractual cash flows (both guaranteed and discretionary) arising from current contracts, regardless of whether they are paid to current or future policyholders.

8. The boards' respective decisions on the 'mirroring approach' are designed to achieve the same overall objective (ie to measure and present the part of the obligation that relates to the underlying items on the same basis as those underlying items). In most cases, the different decisions should produce the same outcome. However, there are situations where, in accordance with the IASB's tentative decisions, mirroring would apply but in accordance with the FASB's tentative decisions, mirroring would not apply. For example:

- (a) If payments to a policyholder are contractually based on the fair value of real estate but the real estate is measured at cost in the financial statements of the insurer, then:
- (i) In accordance with the IASB's tentative decision, the insurance liability would reflect the cost based measurement of the underlying real estate.
 - (ii) In accordance with the FASB's decision, no adjustment would be made to the measurement of the insurance liability. The FASB does not consider that the difference between the expected payment to policyholders (which is based on the fair value of the real estate) and the cost based measurement of the real estate is a timing difference that is expected to reverse within the boundary of the insurance contract when the contractual basis of payments to policyholders is fair value. This is because the insurer may use other funds to pay the policyholder rather than sell the real estate or transfer the real estate to the policyholder. If the insurer did sell the real estate, the obligation to the policyholder would not change and the cumulative losses on the insurance obligation recognised in previous periods would be offset by the gain on the sale of the real estate.
- (b) If payments to a policyholder are contractually based on the net fair value of a pool of investments (i.e., the fund in which a policyholder elects to invest as part of their variable insurance contract) but all or some of the investments in the pool are measured at amortized cost in the financial statements of the insurer, then:
- (i) In accordance with the IASB's tentative decision, the insurance liability would reflect the amortised cost based measurement of the underlying pool or assets.
 - (ii) In accordance with the FASB's tentative decision, no adjustment would be made to the insurance liability. The FASB does not believe that the difference between the expected payment to policyholders (which is based on the

net fair value of the pool of investments) and the amortized cost of the underlying investments, will necessarily reverse when payments are made to the policyholder. This is different from when the contractual obligation is based on amortised cost and the insurer measures the underlying assets at fair value. If the insurer were to sell the underlying asset, the insurer would be required to share with the policyholder any difference between the fair value of the asset and its amortised cost. Consequently, the FASB believe that adjusting the measurement of the liability in these circumstances to reflect the fair value measurement of the assets results in the insurer correctly reporting equity and the obligation.

9. At the May 2012 joint meeting, the boards tentatively decided to present in OCI changes in the insurance liability arising from changes in discount rate. Interest expense presented in profit or loss would be based on the discount rate at inception of the insurance contract.

Illustration of tentative decisions

10. Previous Board papers have illustrated how the tentative decisions for participating contracts would apply to simple contracts. However, those papers were presented to the boards before the decision was taken to present in OCI changes in the insurance liability arising from changes in discount rate.
11. At the May 2012 meeting, some Board members requested that we clarify how the OCI decision would affect participating contracts. The examples in this paper respond to that request.
12. The examples assume that the mirroring decisions will apply in each of the scenarios described. However, as noted in paragraph 8 the FASB's tentative decisions on mirroring do not apply to all participating contracts.

13. Throughout the paper, the staff have assumed that the mirroring decisions take precedence over the decision to present in OCI changes in the insurance liability arising from changes in discount rate (ie the mirroring decisions “trump” the OCI decision). We note that if this were not the case the accounting mismatches in profit or loss and OCI that the mirroring decisions were intended to reduce would still arise.
14. The examples illustrate the following points:
- (a) To the extent that cash flows are dependent on the performance of underlying assets, the mirroring decisions described in paragraph 7(a) mean that the decision to present changes in the insurance liability arising from changes in discount rates in OCI is not relevant. This is because the presentation of changes in the asset dependent cash flows of the insurance liability mirror the presentation of the underlying asset. Consequently:
- (i) if the underlying assets are measured at fair value through profit or loss, the changes in fair value of the asset dependent cash flows of the insurance liability are presented in profit or loss.
 - (ii) if the underlying assets are financial assets measured at fair value through OCI, interest on the asset dependent cash flows of the insurance liability is presented in profit or loss using the same asset-based discount rate as is used to present interest income in profit or loss on the assets. The effects of changes in the discount rate are presented in OCI.
 - (iii) if the underlying assets are financial assets measured at amortised cost, interest on the asset dependent cash flows of the insurance liability is presented in profit or loss using the same asset-based discount rate as is used to present interest income in profit or loss on the assets.
- (b) The mirroring decisions do not apply to cash flows that are not dependent on the underlying assets. Consequently, the OCI decision summarised in paragraph 9 is relevant for those cash flows and:

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- (i) Interest expense on the non-asset dependent cash flows is presented in profit or loss using the rate locked-in at inception of the contract.
- (ii) The effects of changes in discount rate on the present value of the non-asset dependent cash flows are presented in OCI.

15. The following examples also illustrate that combining both the OCI decision and the mirroring decision can be operationally complex. However, the staff believe that the information presented in both the statement of financial position and the statement of comprehensive income is useful and understandable for users of financial statements.

Examples

16. The following examples are used to illustrate the boards' tentative decisions

- (a) Participating contract with no guarantees (paragraphs 17 - 25):
 - (i) Underlying assets at fair value through profit or loss (paragraphs 20 – 21) ;
 - (ii) Underlying assets at fair value through OCI (paragraphs 22 – 23);
 - (iii) Underlying assets at amortised cost (paragraphs 24 – 25).
- (b) Participating contract with a guaranteed return of capital (paragraphs 26 – 38):
 - (i) Underlying assets at fair value through profit or loss (paragraphs 33 – 34);
 - (ii) Underlying assets at fair value through OCI (paragraphs 35 – 36);
 - (iii) Underlying assets at amortised cost (paragraphs 37 – 38).

Participating contract with no guarantees

17. The following example illustrates how the tentative decisions apply to a participating contract that provides the policyholder with no guaranteed return including no guaranteed return of capital. The example has been kept simple to better illustrate the tentative decisions.

Assumptions

18. We have used the following simplified assumptions:

- (a) An upfront premium of CU 1000 is received.
- (b) The contract term is 10 years.
- (c) The policyholder will receive 90% of a specified pool of assets held by the insurer. There is no guaranteed return and the policyholder could receive less than the capital it has invested.
- (d) Interest rates during the period are as follows (a flat yield curve is assumed):

Year	Interest rate assets
0	5.0%
1	5.0%
2	4.0%
3-10	4.0%

- (e) The whole of the CU 1000 premium (including the insurer's residual margin) is initially invested in fixed rate assets with a duration of 5 years. At the end of the first five years, the proceeds from those investments are reinvested in assets with a duration of 5 years.

- (f) Other than changes in interest rates, there are no other changes in assumptions. In addition, there are no lapses and no deaths.
 - (g) The residual/single margin for each contract at the start of the period is recognised in profit or loss on a straight-line basis over the term of the contract.
19. In this example, payments to the policyholder are entirely dependent on the value of the underlying assets. Consequently, the mirroring decisions apply to all cash flows.

Illustrations

Assets at fair value through profit or loss

20. The following shows the financial statements if the assets backing this contract are measured at fair value through profit or loss.
21. In this example:
- (a) The insurance liability is equal to 90% of the fair value of the underlying assets.
 - (b) In accordance with the mirroring decisions, changes in the insurance liability are all presented in profit or loss. The decision to present in OCI changes in the insurance liability arising from changes in discount rate is not relevant.
 - (c) Net profit or loss reflects the insurer's 10% interest in the underlying assets (measured at fair value) and the release of the margin.

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Assets at FVPL																								
													Year											
													0	1	2	3	4	5	6	7	8	9	10	
Balance sheet																								
Asset at fair value														1000.0	1050.0	1134.6	1180.0	1227.2	1276.3	1327.3	1380.4	1435.6	1493.1	1552.8
Liability at current value														900.0	945.0	1021.1	1062.0	1104.5	1148.7	1194.6	1242.4	1292.1	1343.8	1397.5
Margin														100.0	90.0	80.0	70.0	60.0	50.0	40.0	30.0	20.0	10.0	0.0
														0.0	15.0	33.5	48.0	62.7	77.6	92.7	108.0	123.6	139.3	155.3
Comprehensive income																								
Investment income															50.0	84.6	45.4	47.2	49.1	51.1	53.1	55.2	57.4	59.7
Margin release															10	10	10	10	10	10	10	10	10	10
Change in current value liability															45.0	76.1	40.8	42.5	44.2	45.9	47.8	49.7	51.7	53.8
															15.0	18.5	14.5	14.7	14.9	15.1	15.3	15.5	15.7	16.0
Equity																								
<i>Retained earnings</i>																								
Opening															0.0	15.0	33.5	48.0	62.7	77.6	92.7	108.0	123.6	139.3
Profit															15.0	18.5	14.5	14.7	14.9	15.1	15.3	15.5	15.7	16.0
Closing															15.0	33.5	48.0	62.7	77.6	92.7	108.0	123.6	139.3	155.3
															0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Assets at fair value through OCI

22. The following shows the financial statements if the assets backing this contract are measured at fair value through OCI.
23. In this example:
- (a) The insurance liability is equal to 90% of the fair value of the underlying assets.
 - (b) In accordance with the mirroring decisions, changes in the insurance liability are presented in the same way as changes in the underlying assets (ie they are split between profit or loss and OCI). Interest expense presented in profit or loss on the insurance liability is calculated using the same asset-based discount rate as is used to present interest income in profit or loss (5.0% in years 1-5 and 4.0% in years 6-10) and is equal to 90% of the interest income on the underlying assets. The effect of changes in discount rate on the measurement of the asset dependent cash flows is presented in OCI.
 - (c) Net profit or loss reflects the insurer's 10% interest in the underlying assets measured on an amortised cost basis and the release of the residual margin.
 - (d) Net OCI reflects the effect of changes in interest rates on the insurer's 10% interest in the underlying asset.
 - (e) Cumulative OCI equals the difference between the fair value and the amortised cost of the insurer's 10% interest in the underlying assets.

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	Year											
	0	1	2	3	4	5	6	7	8	9	10	
Assets at FVOCI												
Assets at fair value	1000.0	1050.0	1134.6	1180.0	1227.2	1276.3	1327.3	1380.4	1435.6	1493.1	1552.8	
Liability (mirroring)	900.0	945.0	1021.1	1062.0	1104.5	1148.7	1194.6	1242.4	1292.1	1343.8	1397.5	
Margin	100.0	90.0	80.0	70.0	60.0	50.0	40.0	30.0	20.0	10.0	0.0	
	0.0	15.0	33.5	48.0	62.7	77.6	92.7	108.0	123.6	139.3	155.3	
Profit or loss												
Interest income		50.0	52.5	55.1	57.9	60.8	51.1	53.1	55.2	57.4	59.7	
Margin release		10	10	10	10	10	10	10	10	10	10	
Interest expense		45.0	47.3	49.6	52.1	54.7	45.9	47.8	49.7	51.7	53.8	
		15.0	15.3	15.5	15.8	16.1	15.1	15.3	15.5	15.7	16.0	
OCI												
Asset		0.0	32.1	-9.7	-10.7	-11.7	0.0	0.0	0.0	0.0	0.0	
Liability		0.0	28.9	-8.8	-9.6	-10.5	0.0	0.0	0.0	0.0	0.0	
		0.0	3.2	-1.0	-1.1	-1.2	0.0	0.0	0.0	0.0	0.0	
Comprehensive income		15.0	18.5	14.5	14.7	14.9	15.1	15.3	15.5	15.7	16.0	
Equity												
Opening		0.0	15.0	33.5	48.0	62.7	77.6	92.7	108.0	123.6	139.3	
Profit		15.0	15.3	15.5	15.8	16.1	15.1	15.3	15.5	15.7	16.0	
OCI		0.0	3.2	-1.0	-1.1	-1.2	0.0	0.0	0.0	0.0	0.0	
Closing		15.0	33.5	48.0	62.7	77.6	92.7	108.0	123.6	139.3	155.3	
check		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	

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Assets at amortised cost

24. The following shows the financial statements if the assets backing this contract are measured at amortised cost.
25. In this example:
- (a) The insurance liability is equal to 90% of the amortised cost of the underlying assets.
 - (b) Interest expense presented in profit or loss on the insurance liability is calculated using the same asset-based discount rate as is used to present interest income in profit or loss (5.0% in years 1-5 and 4.0% in years 6-10) and is equal to 90% of the interest income on the underlying assets.
 - (c) Net profit or loss reflects the insurer's 10% interest in the underlying assets measured on an amortised cost basis and the release of the residual margin.
 - (d) No amounts are reported in OCI in this example.

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	Year												
	0	1	2	3	4	5	6	7	8	9	10		
Assets at amortised cost													
Assets at amortised cost	1000.0	1050.0	1102.5	1157.6	1215.5	1276.3	1327.3	1380.4	1435.6	1493.1	1552.8		
Liability (mirroring)	900.0	945.0	992.3	1041.9	1094.0	1148.7	1194.6	1242.4	1292.1	1343.8	1397.5		
Margin	100.0	90.0	80.0	70.0	60.0	50.0	40.0	30.0	20.0	10.0	0.0		
	0.0	15.0	30.3	45.8	61.6	77.6	92.7	108.0	123.6	139.3	155.3		
Profit or loss													
Investment income		50.0	52.5	55.1	57.9	60.8	51.1	53.1	55.2	57.4	59.7		
Margin release		10	10	10	10	10	10	10	10	10	10		
Interest expense		45.0	47.3	49.6	52.1	54.7	45.9	47.8	49.7	51.7	53.8		
		15.0	15.3	15.5	15.8	16.1	15.1	15.3	15.5	15.7	16.0		
Equity													
<i>Retained earnings</i>													
Opening		0.0	15.0	30.3	45.8	61.6	77.6	92.7	108.0	123.6	139.3		
Profit		15.0	15.3	15.5	15.8	16.1	15.1	15.3	15.5	15.7	16.0		
Closing		15.0	30.3	45.8	61.6	77.6	92.7	108.0	123.6	139.3	155.3		
check		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Participating contract with guaranteed return of capital

26. The following example illustrates how the tentative decisions apply to a participating contract which guarantees policyholders a return of their capital.

Assumptions

27. To illustrate the interaction between the mirroring decisions and the OCI decision we have used the following simplified assumptions:

- (a) An upfront premium of CU 1000 is received.
- (b) The contract term is 10 years.
- (c) At the end of 10 years, the policyholder is guaranteed a payment of at least CU 1000 (ie the policyholder is guaranteed the return of its capital). In practice, many contracts of this type include a minimum guaranteed interest rate. In this example, the minimum guaranteed interest rate is assumed to be zero in order to keep the example simple.
- (d) The policyholder will receive 90% of the returns of a specified pool of assets held by the insurer, if those returns are positive.
- (e) Interest rates during the period are as follows (a flat yield curve is assumed):

Year	Interest rate assets	Discount rate non- participating liabilities
0	5.0%	4.5%
1	5.0%	4.5%
2	4.0%	3.5%
3-10	4.0%	3.5%

- (f) The premium is initially invested in fixed rate assets with a duration of 5 years. At the end of the first five years, the proceeds from those investments are reinvested in assets with a duration of 5 years.
- (g) Other than changes in interest rates, there are no other changes in assumptions. In addition, there are no lapses and no deaths.
- (h) The residual/single margin for each contract at the start of the period is recognised in profit or loss on a straight-line basis over the term of the contract.

Components of payments to policyholders

28. Payments to policyholders under this contract have the following three components:
- (a) The guaranteed amount (CU 1000); plus
 - (b) 90% of the increase in value of the pool of assets = $90\% * (\text{Value of the assets} - 1000)$; plus
 - (c) The value of an option for the policyholder to put 90% of the assets to the insurer at maturity for a strike price of CU900.
29. These components can be re-expressed as:
- (a) 90% of the assets; plus
 - (b) a fixed payment of CU100; plus
 - (c) the value of the option.
30. The first component of the cash flows (identified in paragraph 29(a)) behaves in the same way as 90% of the total assets to which the liability is linked. Consequently, the mirroring decisions apply to these cash flow. The measurement of this component of the liability mirrors the measurement of the corresponding assets and changes in this component of the liability are presented in the same way as changes in the underlying assets.
31. The second component of the cash flows (identified in paragraph 29(b)) behaves in the same way as a fixed payment of CU 100. Because this cash flow is not

dependent on the underlying assets, the mirroring decision is not relevant. This component is measured at a current value. Changes in this component of the liability arising from changes in discount rate are presented in OCI.

32. The mirroring decision is not relevant for the option component of the liability (identified in paragraph 29(c)) because, in accordance with the boards' tentative decisions, changes in the value of the option will be presented in profit or loss. The example assumes the following values for the option (the value of the option drops significantly at the end of year 2 because of the fall in interest rates):

Time	0	1	2	3	4	5	6	7	8	9	10
Value	5.0	4.5	3.0	2.6	2.2	1.8	1.4	1.0	0.6	0.3	0.0

Illustrations

Assets at fair value through profit or loss

33. The following shows the financial statements if the assets backing this contract are measured at fair value through profit or loss.

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Assets at FVPL												
Year												
Balance sheet	0	1	2	3	4	5	6	7	8	9	10	
Asset at fair value	1000.0	1050.0	1134.6	1180.0	1227.2	1276.3	1327.3	1380.4	1435.6	1493.1	1552.8	
Current value of asset dependent cash flows	-900.0	-945.0	-1021.1	-1062.0	-1104.5	-1148.7	-1194.6	-1242.4	-1292.1	-1343.8	-1397.5	
Current value of fixed cash flows	-64.4	-67.3	-75.9	-78.6	-81.4	-84.2	-87.1	-90.2	-93.4	-96.6	-100.0	
Option	-5.0	-4.5	-3.0	-2.6	-2.2	-1.8	-1.4	-1.0	-0.6	-0.3	0.0	
Liability at current value	-969.4	-1016.8	-1100.1	-1143.2	-1188.0	-1234.7	-1283.1	-1333.6	-1386.0	-1440.7	-1497.5	
Margin	-30.6	-27.5	-24.5	-21.4	-18.4	-15.3	-12.2	-9.2	-6.1	-3.1	0.0	
	0.0	5.7	10.0	15.4	20.8	26.3	31.9	37.7	43.5	49.3	55.3	
Profit or loss												
Investment income		50.0	84.6	45.4	47.2	49.1	51.1	53.1	55.2	57.4	59.7	
Margin release		3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	
Change in current value asset dependent cash flows		-45.0	-76.1	-40.8	-42.5	-44.2	-45.9	-47.8	-49.7	-51.7	-53.8	
Interest expense on fixed cash flows		-2.9	-3.0	-3.2	-3.3	-3.5	-3.6	-3.8	-3.9	-4.1	-4.3	
Change in value option		0.5	1.5	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	
		5.7	10.0	4.8	4.9	4.9	5.0	5.0	5.0	5.0	5.0	
OCI												
Asset		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Liability		0.0	-5.6	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9	
		0.0	-5.6	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9	
Comprehensive income		5.7	4.4	5.3	5.4	5.5	5.6	5.7	5.8	5.8	6.0	
Equity												
Opening		0.0	5.7	10.0	15.4	20.8	26.3	31.9	37.7	43.5	49.3	
Profit		5.7	10.0	4.8	4.9	4.9	5.0	5.0	5.0	5.0	5.0	
OCI		0.0	-5.6	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9	
Closing		5.7	10.0	15.4	20.8	26.3	31.9	37.7	43.5	49.3	55.3	
		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	

34. In this example:

- (a) Asset dependent cash flows are measured on the same basis as the underlying assets. Consequently, the asset dependent cash flows are equal to 90% of the fair value of the underlying assets. (Alternatively, the asset dependent cash flows can be viewed as being discounted using the current asset-based rate).
- (b) The fixed cash flows of CU100 are discounted using a current liability-based rate.
- (c) Investment income is equal to the change in fair value of the underlying assets. Investment income increases significantly in year 2 because of the fall in interest rates from 5.0% to 4.0%.
- (d) The change in current value of asset dependent cash flows is equal to 90% of the change in fair value of the underlying assets. There is a significant increase in the current value of the asset dependent cash flows in year 2 because of the fall in interest rates from 5.0% to 4.0%. The full change in value of the asset dependent cash flows is presented in profit of loss. There are no amounts presented in OCI in respect of the asset dependent cash flows. This is because the mirroring decisions require the change in value of the asset dependent cash flows to be presented in the same way as the change in value of the underlying assets (ie through profit or loss).
- (e) In accordance with the OCI decision, interest expense on the fixed cash flows is presented in profit or loss using the liability based rate locked in at inception (4.5%). The effect of changes in the discount rate on these cash flows is presented in OCI. Cumulative OCI shows the difference between the current value of the fixed cash flows and the amortised cost of the fixed cash flows.
- (f) Changes in the value of the option are presented in profit or loss.
- (g) Profit or loss reflects the insurer's:
 - (i) 10% interest in the assets;

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- (ii) the release of the margin;
- (iii) interest expense on the fixed cash flows;
- (iv) the change in value of the option.

Assets at fair value through OCI

35. The following shows the financial statements if the assets backing this contract are measured at fair value through OCI.

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	Year											
	0	1	2	3	4	5	6	7	8	9	10	
Assets at FVOCI												
Assets at fair value	1000.0	1050.0	1134.6	1180.0	1227.2	1276.3	1327.3	1380.4	1435.6	1493.1	1552.8	
Current value of asset dependent cash flows	-900.0	-945.0	-1021.1	-1062.0	-1104.5	-1148.7	-1194.6	-1242.4	-1292.1	-1343.8	-1397.5	
Current value of fixed cash flows	-64.4	-67.3	-75.9	-78.6	-81.4	-84.2	-87.1	-90.2	-93.4	-96.6	-100.0	
Option	-5.0	-4.5	-3.0	-2.6	-2.2	-1.8	-1.4	-1.0	-0.6	-0.3	0.0	
Liability at current value	-969.4	-1016.8	-1100.1	-1143.2	-1188.0	-1234.7	-1283.1	-1333.6	-1386.0	-1440.7	-1497.5	
Margin	-30.6	-27.5	-24.5	-21.4	-18.4	-15.3	-12.2	-9.2	-6.1	-3.1	0.0	
	0.0	5.7	10.0	15.4	20.8	26.3	31.9	37.7	43.5	49.3	55.3	
Profit or loss												
Interest income		50.0	52.5	55.1	57.9	60.8	51.1	53.1	55.2	57.4	59.7	
Margin release		3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	
Interest expense on asset dependent cash flows		-45.0	-47.3	-49.6	-52.1	-54.7	-45.9	-47.8	-49.7	-51.7	-53.8	
Interest expense on fixed cash flows		-2.9	-3.0	-3.2	-3.3	-3.5	-3.6	-3.8	-3.9	-4.1	-4.3	
Change in value option		0.5	1.5	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	
		5.7	6.8	5.8	5.9	6.1	5.0	5.0	5.0	5.0	5.0	
OCI												
Asset		0.0	32.1	-9.7	-10.7	-11.7	0.0	0.0	0.0	0.0	0.0	
Liability - asset dependent cash flows		0.0	-28.9	8.8	9.6	10.5	0.0	0.0	0.0	0.0	0.0	
Liability - fixed cash flows		0.0	-5.6	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9	
		0.0	-2.4	-0.5	-0.5	-0.6	0.7	0.7	0.8	0.9	0.9	
Comprehensive income		5.7	4.4	5.3	5.4	5.5	5.6	5.7	5.8	5.8	6.0	
Equity												
Opening		0.0	5.7	10.0	15.4	20.8	26.3	31.9	37.7	43.5	49.3	
Profit		5.7	6.8	5.8	5.9	6.1	5.0	5.0	5.0	5.0	5.0	
OCI		0.0	-2.4	-0.5	-0.5	-0.6	0.7	0.7	0.8	0.9	0.9	
Closing		5.7	10.0	15.4	20.8	26.3	31.9	37.7	43.5	49.3	55.3	
check		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	

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36. In this example:

- (a) Assets are measured at fair value with changes in the fair value of the assets arising from changes in discount rate presented in OCI. Interest income presented in profit or loss is equal to interest at the locked-in asset based rate (5.0% in years 1-5 and 4.0% in years 6-10).
- (b) Asset dependent cash flows are measured on the same basis as the underlying assets. Consequently, the asset dependent cash flows are equal to 90% of the fair value of the underlying assets. (Alternatively, the asset dependent cash flows can be viewed as being discounted using the current asset-based rate).
- (c) The change in current value of asset dependent cash flows is equal to 90% of the change in fair value of the underlying assets. There is a significant increase in the current value of the asset dependent cash flows in year 2 because of the fall in interest rates from 5.0% to 4.0%. In accordance with the mirroring decisions, the change in value of the asset dependent cash flows is split between OCI and profit or loss. This is because the change in value of the underlying assets is also split between profit or loss and OCI. Interest expense presented in profit of loss on the asset dependent cash flows is calculated using the same asset-based discount rate as is used to present interest income in profit or loss on the assets (5.0% in years 1-5 and 4.0% in years 6-10). The effect of changes in discount rate on the measurement of the asset dependent cash flows is presented in OCI.
- (d) The fixed cash flows of CU100 are discounted using a current liability-based rate.
- (e) Changes in the value of the option are presented in profit or loss.
- (f) In accordance with the OCI decision, interest expense on the fixed cash flows is presented in profit or loss using the liability-based rate locked in at inception (4.5%). The effect of changes in the discount rate on these cash flows is presented in OCI.
- (g) Profit of loss reflects:

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- (i) interest income on the insurer's 10% interest in the assets at a locked-in rate;
 - (ii) the release of the margin;
 - (iii) interest expense on the fixed cash flows;
 - (iv) the change in value of the option.
- (h) Cumulative OCI is made up of three components:
- (i) the difference between the fair value and the amortised cost of the underlying assets;
 - (ii) the difference between the current value of the asset dependent cash flows and the amortised cost of those cash flows; and
 - (iii) the difference between the current value of the fixed cash flows and the amortised cost of the fixed cash flows.

Assets at amortised cost

37. The following shows the financial statements if the assets backing this contract are measured at amortised cost.

	Year											
	0	1	2	3	4	5	6	7	8	9	10	
Assets at amortised cost												
Assets at amortised cost	1000.0	1050.0	1102.5	1157.6	1215.5	1276.3	1327.3	1380.4	1435.6	1493.1	1552.8	
Amortised cost of asset dependent cash flows	-900.0	-945.0	-992.3	-1041.9	-1094.0	-1148.7	-1194.6	-1242.4	-1292.1	-1343.8	-1397.5	
Current value of fixed cash flows	-64.4	-67.3	-75.9	-78.6	-81.4	-84.2	-87.1	-90.2	-93.4	-96.6	-100.0	
Option	-5.0	-4.5	-3.0	-2.6	-2.2	-1.8	-1.4	-1.0	-0.6	-0.3	0.0	
Margin	-30.6	-27.5	-24.5	-21.4	-18.4	-15.3	-12.2	-9.2	-6.1	-3.1	0.0	
	0.0	5.7	6.8	13.1	19.6	26.3	31.9	37.7	43.5	49.3	55.3	
Profit or loss												
Investment income		50.0	52.5	55.1	57.9	60.8	51.1	53.1	55.2	57.4	59.7	
Margin release		3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	
Interest expense on asset dependent cash flows		-45.0	-47.3	-49.6	-52.1	-54.7	-45.9	-47.8	-49.7	-51.7	-53.8	
Interest expense on fixed cash flows		-2.9	-3.0	-3.2	-3.3	-3.5	-3.6	-3.8	-3.9	-4.1	-4.3	
Change in value option		0.5	1.5	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	
		5.7	6.8	5.8	5.9	6.1	5.0	5.0	5.0	5.0	5.0	
OCI												
Asset		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Liability - asset dependent cash flows		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Liability - fixed cash flows		0.0	-5.6	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9	
		0.0	-5.6	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9	
Comprehensive income		5.7	1.2	6.3	6.5	6.7	5.6	5.7	5.8	5.8	6.0	
Equity												
<i>Retained earnings</i>												
Opening		0.0	5.7	6.8	13.1	19.6	26.3	31.9	37.7	43.5	49.3	
Profit		5.7	6.8	5.8	5.9	6.1	5.0	5.0	5.0	5.0	5.0	
OCI		0.0	-5.6	0.5	0.6	0.6	0.7	0.7	0.8	0.9	0.9	
Closing		5.7	6.8	13.1	19.6	26.3	31.9	37.7	43.5	49.3	55.3	
check		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	

38. In this example:

- (a) Assets are measured at amortised cost. Interest income presented in profit or loss is equal to interest at the locked-in asset based rate (5.0% in years 1-5 and 4.0% in years 6-10).
- (b) In accordance with the mirroring decisions, asset dependent cash flows are measured and presented on the same basis as the underlying assets. The amortised cost of the asset dependent cash flows is equal to 90% of the amortised cost of the underlying assets. The rate used to discount the asset based cash flows and to present interest expense in profit or loss is the same asset-based discount rate that is used to present interest income on the assets in profit or loss (5.0% in years 1-5 and 4.0% in years 6-10). No amounts are presented in OCI in respect of the asset dependent cash flows.
- (c) The fixed cash flows are discounted using a current liability-based rate.
- (d) Changes in the value of the option are presented in profit or loss.
- (e) Profit or loss is the same as the FVOCI example above and reflects:
 - (i) interest income on the insurer's 10% interest in the assets at a locked-in rate;
 - (ii) the release of the margin;
 - (iii) interest expense on the fixed cash flows;
 - (iv) the change in value of the option.
- (f) In accordance with the OCI decision, interest expense on the fixed cash flows is presented in profit or loss using the liability based rate locked in at inception (4.0%). The effect of changes in the discount rate on these cash flows is presented in OCI. Cumulative OCI, shows the difference between the current value of the fixed cash flows and the amortised cost of the fixed cash flows.

Question for the boards

Question 1

Is further clarification required of how changes in in the insurance liability (including the effect of changes in discount rate) would be presented in comprehensive income when the mirroring decisions apply?

Presentation of changes in discount rate for participating contracts to which the mirroring decisions do not apply - FASB ONLY³

39. The examples above illustrate the FASB's tentative decisions for those participating contracts to which the mirroring decisions apply. However, as noted in paragraph 7, the FASB's tentative decision regarding mirroring only applies to:
- (a) the measurement of insurance contract fulfilment cash flows and to the measurement of the obligation from any nondiscretionary performance-linked participating features that both contractually depend wholly or partly on the performance of other assets or liabilities recognized in the insurer's statement of financial position, or the performance of the insurer itself, and are a component of an insurance contract's obligations.
 - (b) eliminating accounting mismatches that reflect timing differences between the current liability and the measurement of the underlying items in the U.S. GAAP statement of financial position that are expected to reverse within the boundary of the insurance contract. An underlying item is defined as the asset or liability (or group of assets or liabilities) on which the cash flows resulting from the participation feature depend.
40. However, there are other participating contracts to which the FASB's mirroring decisions would not apply. Typically, these are contracts where the contractual obligation to the policyholder is based on the fair value of the underlying item to which it is contractually linked (e.g. a direct pass-through of the return on a

³ This section is not relevant to the IASB because the IASB has decided that mirroring should apply to all participating contracts.

specified pool of assets - see paragraph 8. These may include unit-linked, variable contracts, separate accounts, segregated funds, and super annuitisation funds.

However, there may be other contracts that will fall into this category.

41. If the boards' tentative decision to present in OCI changes in the insurance liability arising from changes in interest rate are applied to these contracts and the underlying items are measured at fair value through profit or loss, then an accounting mismatch will arise. Consequently, the staff believe that changes in the insurance liability arising from changes in the discount rates should be presented in profit or loss if the underlying items on which the participation is based are recorded at fair value through profit or loss.
42. This is consistent with the boards' tentative decision that if the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence. In addition, this approach would ensure that changes in the measurement of the liability would be presented in the same way as changes in the underlying assets. The staff believe that this approach better reflects the economics of contracts of this type. This is because, if the insurer's contractual obligation to the policyholder is directly linked to a pool of assets measured at fair value through profit or loss, any movements in the asset value that are recorded through profit or loss would be offset by the requirement to return that movement to the policyholder. For example, a policyholder's account value of CU 1,000 is backed by the fair value of a pool of assets of CU 1,000. If the fair value of the pool of assets increases to CU 1,100 resulting in CU 100 gain being recognized in profit or loss, the insurer's obligation to the policyholder would also increase to CU 1,100 and the CU 100 would be recorded in profit or loss as an increase in the liability.
43. This also would result in the same accounting as the IASB for contracts where the mirroring decision does not apply and the assets or liabilities that directly impact the insurance contract liability are reported at fair value through profit or loss. A difference would remain when the assets or liabilities that directly impact the insurance contract liability are reported at amortized cost. For these contracts,

unless the mirroring decision applies, the FASB staff do not believe that the measurement of the liability should be impacted by the insurer's classification of its assets and therefore would measure these contracts consistent with the boards' tentative decisions for non-participating contracts (i.e., changes in the insurance liability arising from changes in the discount rate would be presented in OCI). This may be the case when the contractual obligation is directly impacted by the changes in fair value of assets that are recorded at amortized cost (e.g., real estate or a pool of assets). The accounting would be similar to the treatment of the insurer's interest in the examples above.

Question 2:

Does the FASB agree that:

For contracts to which the mirroring decisions do not apply and where the contractual obligation to the policyholder is based on the fair value of the underlying items, changes in the insurance liability arising from changes in discount rates should be presented in profit or loss if the underlying items on which the participation is based are recorded at fair value through profit or loss?

Appendix A: Examples of participating contracts

A1. This appendix is carried forward from Appendix B of agenda paper 3F/ FASB Memorandum 60F of the March 2011 Joint Board meeting and paragraph 16 of that agenda paper.

Appendix A

- A2. Participating contracts generally contain a guaranteed element as well as a participating feature. The participating feature gives rise to payments to the policyholder, paid out from a distinct share of surpluses, after providing the guaranteed benefits. In some cases the obligation to pay to the policyholders is restricted, for example, to realised surpluses. This means that although the insurer may decide when to realise surpluses and this may establish a timing difference between the amounts recognised in the financial statements and the corresponding amounts immediately available for distribution to policyholders, the amounts are still only available for policyholders. The insurer usually has, to an extent, discretion over the amount and/ or timing of these extra distributions to the policyholders.
- A3. In most countries this discretion is (partially) constrained by legal or regulatory requirements as well as by competitive constraints. In many countries the “contribution principle” applies. The contribution principle means that the distribution of the aggregate accumulated surplus among the policyholders is in the same proportion as each respective contract (or portfolio of contracts) that has contributed to the accumulated surplus.
- A4. The following information on country-specific types of participating contracts is based on an (internal) survey by members of the Insurance Accounting Committee of the International Actuarial Association (IAA). We thank them for providing the information. They are not responsible for how the staff have summarised the information.
- A5. Belgian participating contracts provide a contractual right to share in surplus, but usually do not give specific guidance on how the policyholder participates in the

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surplus or which share belongs to the policyholder. The insurer determines annually the policyholders' share of surplus, which is solely based on the insurer's discretion (the insurer is entirely free to pay the policyholder any amount between 0 to 100% of the surplus). After determining the policyholders' share in surplus for the current year, the Belgian regulators require the insurer to pay out 80% of the amounts set aside for allocation to policyholders in the following year. The remaining 20% are to be payable to policyholders in later periods.

- A6. Finnish participating contracts determine the policyholders' share entirely based on the insurer's discretion. Actual payments are only driven by competitive market pressure. The insurer decides when to realise surpluses, the individual policyholder's share in that surplus and the timing of the actual allocation. The regulator ensures that the insurer does not allocate surpluses if doing so potentially endangers the insurer's financial stability.
- A7. South African life insurers have discretion on the policyholders' share in surplus, as well as on the amount and timing of its allocation or distribution to the individual policyholder. The amounts set aside for policyholders can be negative if they are expected to be recovered during the following three years.
- A8. In Australia the policyholders' share in surplus is set aside and allocated to the individual policyholder according to a formula. Legally, the insurer is obliged to set aside 80% of the surplus for policyholders. Some contracts grant an even higher percentage. The amount set aside may become negative and carried forward. If the insurer voluntarily pays more than 80% (or whatever contractually is required), that can be carried forward, thus reducing future amounts to be set aside to pay dividends to future policyholders
- A9. Canadian participating contracts require an annual allocation of amounts to individual policyholders, payable immediately in the following year. Law requires that the directors must adopt a formal dividend policy and adopt methods for allocation, which an appointed actuary must approve. In Canada there is little discretion in determining the amount or timing of the surplus once allocated. The

contribution principle is followed, with the Appointed Actuary recommending dividends to the entity's Board.

- A10. Most Japanese participating contracts force the insurer to immediately set aside policyholders' contractually specified share in the realised surplus. These amounts are not immediately payable to the individual policyholder, but rather are aggregated over time. The timing of the irrevocable allocation is at the discretion of the insurer, even though the surplus is already realised. The amounts set aside are revocable and loss absorbing, including those referring to future periods of the individual contract.
- A11. In the US, the types of contracts are diverse, partly due to significantly different state regulations. Some states allow insurers to apply significant discretion in declaring dividend scales; however, overall they are subject to regulatory control. Regulators are expected to intervene in case of inadequate dividend scales, but that remains untested since in the past all insurers acted in accordance with regulatory rules. If stock insurers issue participating contracts, the amounts distributable to stockholders may be limited by some state laws.
- A12. In the UK participating features are contractually and legally established. The sources to determine the surplus need to be specified and may include sources from non-participating contracts. Policyholders' individual share is typically required to be at least nine times of any allocation to shareholders from aggregated unallocated surplus, to be allocated immediately to policyholders when amounts are allocated to shareholders.
- A13. In the Czech Republic and Slovakia participating contracts determine the policyholder's share as a fixed percentage of the realised surplus. The insurer's only discretion is when to realise the surplus, as there is no discretion on timing of allocation or amount of payment to the individual policyholder.
- A14. Norwegian law prescribes that the policyholders' share in surpluses has to be two thirds of each annual surplus (partly including unrealised gains). When policies terminate, there is an obligatory payment of 75% of any surpluses (including unrealised gains) determined at that point in time. Insurers can decide when to

realise gains (apart from terminating contracts), but there is no further discretion available.

- A15. In Italy the participation feature is guaranteed by law to be an entity-wide average of 85% of the realised surpluses (unrealised gains and losses excluded). The exact policyholder's share in the surplus is specified in the individual contract as a specific percentage of investment earnings. The individual policyholder receives its share every year according to the results of the previous year.
- A16. French life insurers issue participating investment contracts with a guaranteed minimum annual rate of return on premiums paid, a distinct share in investment returns on the entire surplus of the entity. Under French law the insurer can immediately forward shares in realised surplus to individual policyholders. The remaining amount of the overall required share for policyholders is set aside. However, the insurer has some discretion regarding the timing of the allocation to the individual policyholder. The allocation has to be done within 8 years. The amount set aside can be used to cover subsequent losses to some extent and there might be as well a loss carry forward to be recovered by future surplus.
- A17. In some states in the US, e.g. New York, state law requires that the insurer sets a minimum percentage of surplus aside for ultimate distribution to policyholders each year. At the same time the law grants insurers some discretion regarding its ultimate allocation. The contribution principle is considered in this allocation.
- A18. In Germany, virtually all life insurance contracts are participating contracts. There are strict rules determining the share of recognised surplus that has to be set aside for participation of policyholders. Although the subsequent allocation of the amount set aside to individual policyholders is at the discretion of the insurer, the contribution principle is applied. Losses of a period are generally borne by the insurer. Unallocated amounts can be used to cover subsequent losses if otherwise the insurer would be in financial danger. If contracts terminate for any reason, the policyholder receives an appropriate share of unrealised gains allocable to its contract.

Appendix B: Relevant tentative decisions of the boards

B1. In March 2011, the boards tentatively decided:

(a) To clarify that the objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating contracts, ie a current discount rate that reflects the characteristics of the insurance contract liability, updated each reporting period. No method is prescribed for determining the discount rate, but the rate should:

- (i) Be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity but excluding the effect of the insurer's non-performance risk
- (ii) Exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability;
- (iii) Reflect only the effects of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability

(b) To provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependency.

B2. In December 2011, the boards confirmed that the obligation for the performance linked participation feature should be measured in a way that reflects how those underlying items are measured in the US GAAP/ IFRS financial statements. That could be achieved by two methods, which both lead to the same measurement:

- (a) eliminating from the building block approach changes in value not reflected in the measurement of the underlying items, or

- (b) adjusting the insurer's current liability (that is, the contractual obligation incurred to date) to eliminate accounting mismatches that reflect timing differences (between the current liability and the measurement of the underlying items in the US GAAP/IFRS statement of financial position) that are expected to reverse within the boundary of the insurance contract.

B3. That decision confirmed previous decisions of the boards made at separate meetings as follows:

- (a) At the November 30, 2011 FASB board meeting, the FASB tentatively decided the following, as it relates to the measurement of insurance contract fulfilment cash flows and to the measurement of the obligation from any nondiscretionary performance-linked participating features that both contractually depend wholly or partly on the performance of other assets or liabilities recognized on the insurer's statement of financial position, or the performance of the insurer itself, and are a component of an insurance contract's obligations:
 - (i) The obligation due to the performance-linked participating features should be measured based on an insurer's current liability (that is, the contractual obligation incurred to date) adjusted to eliminate accounting mismatches that reflect timing differences between the current liability and the measurement of the underlying items in the U.S. GAAP/IFRS statement of financial position that are expected to reverse within the boundary of the insurance contract. An underlying item is defined as the asset or liability (or group of assets or liabilities) on which the cash flows resulting from the participation feature depend.
 - (ii) Any changes in the liability for the performance-linked participating features should be presented in the same way within the statement of comprehensive income (that is,

consistently in net income and/or other comprehensive income) as the changes in the underlying item.

- (iii) No further adjustments to the measurement of the liability for the performance-linked participating features are deemed necessary for the purposes of reflecting expected cash flows.

(b) At the 11 May 2011 meeting, the IASB tentatively decided that:

- (iv) The measurement of the fulfillment cash flows relating to the policyholder's participation should be based on the measurement in the IFRS financial statements of the underlying items in which the policyholder participates. Such items could be assets and liabilities, the performance of an underlying pool of insurance contracts or the performance of the entity.
- (v) An insurer should reflect, using a current measurement basis, any asymmetric risk-sharing between insurer and policyholder in the contractually linked items arising from a minimum guarantee.
- (vi) An insurer should present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (ie in profit or loss or in other comprehensive income).
- (vii) The same measurement approach should apply to both unit-linked and participating contracts.

B4. In December 2011, the boards also tentatively:

- (a) confirmed that options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives under the financial instrument requirements should be measured within the overall insurance contract obligation using a current, market-consistent, expected value approach.

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- (b) agreed that, when an insurer measures an obligation, created by an insurance contract liability, that requires payment depending wholly or partly on the performance of specified assets and liabilities of insurer, that measurement should include all such payments that result from that contract, whether paid to current or future policyholders.

Appendix C: Excerpts from FASB Memo No. 76A from the November 30, 2011 FASB Board Meeting

17. The staff believes there are several steps in determining the carrying amount of the liability that includes a contractual participation feature. The end result of the first four of these steps is consistent with measurement of the liability for performance-linked participating features that is required under current US GAAP that many believe works well in practice.
- a. Step 1: What is the contractual performance-linked participation feature based on?
 - b. Step 2: How are the **underlying items** or **underlying assets or liabilities** (which are the assets or liabilities on which the cash flows resulting from the participation feature depend) accounted for in the IFRS / US GAAP basis financial statements?
 - c. Step 3: If there is a difference between the step 1 and step 2 measurement bases, should an adjustment be recorded in the IFRS / US GAAP basis financial statements to reflect the different measurement? If an adjustment should be recorded, should it be recorded as an adjustment to the liability determined as part of step 1 or an adjustment to the underlying items?
 - d. Step 4: If an adjustment is required where in the statement of comprehensive income should the adjustment be recorded?
 - e. Step 5: How should the “expected” piece of the cash flows be considered?

Example 1

Assume an asset is purchased at CU 800, pays no interest or dividends, and will mature in 5 years at CU 1300.

An insurance contract with a performance-linked participation feature is concurrently sold. The contractual performance-linked participation feature is based on 90% of the movement of the statutory / regulatory carrying value of the asset which is amortized cost. The terms of this and other contracts in the portfolio obligate the insurer to re-allocate to remaining participating policyholders (purchasing the same product) any variances existing upon a policy lapse between 90% of the cumulative change in fair value of the underlying asset and what is distributed to the policyholder (i.e., the temporary differences in the asset and participation feature measurement survive the lapse of a policy). The IFRS / US GAAP basis carrying value of the asset is fair value.

At the end of the first year the amortized cost of the asset is CU 900 and the fair value of the asset is CU 1,200. Assume for purposes of this example that there will be at least one participating contract in effect at the end of year 5.

Step 1: The 'current' liability for the contractual participation feature is CU 90.

Step 2: Under IFRS / US GAAP the carrying amount of the underlying asset increased by CU 400 or CU 300 more than the increase in the asset's amortized cost.

Step 3: When recording the liability in the IFRS / US GAAP financial statements, if the liability is measured using the 'current' statutory / regulatory values, then the liability would continue to be CU 90 and shareholders equity would increase by CU 310. However, the full CU 310 amount is not available to shareholders in this example. As such, many believe an adjustment to the liability of CU 270 is required to result in the liability for the participation feature being recorded at CU 360 (i.e., 90% of the CU 400 increase in the carrying value of the asset on the IFRS / US GAAP financial statements) resulting in an increase in shareholders' equity of only CU 40.

Step 4: Insurers also need to determine where in the statement of comprehensive income the change in the carrying amount of the underlying item is recorded – net income or OCI. Based on that split, the change in the carrying amount of the performance-linked participating feature will need to be allocated in the IFRS/US GAAP financial statements to either the income statement or OCI.

Step 5: Does an additional adjustment for expected cash flows need to be made since the building block model requires an estimate of expected cash flows?

20. If the performance-linked participation feature is contractually determined on a basis equivalent to how the underlying item is carried on the insurer's IFRS / US GAAP basis financial statements, the staff do not believe there is an accounting mismatch requiring further consideration as part of Step 3. However, if the performance linked participation feature is based on a measurement basis that differs from the IFRS / US GAAP measurement basis for the underlying item, there is an accounting mismatch in the IFRS / US GAAP financial statements that some believe should be addressed.

21. The staff analyzed four scenarios⁴ to ascertain where any accounting mismatches might exist:

- a. The performance linked participation feature is based on the regulatory/statutory measurement of (non-owner occupied) real estate. In many jurisdictions this measurement is amortized cost. Real estate is also measured at amortized cost under US GAAP and IFRS (although IFRS allows a fair value option) in most circumstances. The staff do not believe there is an accounting mismatch after application of steps 1 and 2 in this situation.
- b. The performance linked participation feature is based on the regulatory/statutory measurement of an equity security. In many jurisdictions the measurement of the equity security is based on fair value and under IFRS and US GAAP this equity security may be required to be recorded at fair value. The staff do not believe there is an accounting mismatch after application of steps 1 and 2 in this situation.
- c. The performance linked participation feature is based on the regulatory/statutory measurement of a fixed maturity security (e.g., a corporate bond). In many jurisdictions the regulatory measurement of the bond is based on amortized cost; however under IFRS and US GAAP, this bond may be required to be recorded at fair value – this scenario is similar to that described above in Example 1. To the extent the differences in measurement between the fixed maturity security and performance linked participation feature are expected to reverse during the life of that performance linked participation feature (e.g., where the estimated duration of the participating feature is greater than the estimated duration of the underlying item), the staff believe there is an accounting mismatch after application of steps 1 and 2.
- d. The performance linked participation feature is based on the fair value of (non-owner occupied) real estate. However, as previously noted, the real estate may be recorded at amortized cost under IFRS and US GAAP. The staff believe that there is an accounting mismatch after application of steps 1 and 2 in this scenario (e.g., changes in the market rents equally affect the asset and liabilities, but the carrying amount of the real estate and the performance-linked participation feature do not respond equally to this economic change). However, the staff observe that, to the extent the differences in measurement between the asset and performance linked participation feature are not expected to reverse during the life of that performance

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linked participation feature, these differences do not represent timing differences that should be adjusted for as part of step 3. Any such accounting mismatches are analogous to those that exist more broadly within an insurer's statement of financial position.