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Project	**Insurance contracts**		
Paper topic	Possible adaptations for contracts with participating features		
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Introduction

1. A contract with a participating feature is one in which the policyholder shares with the entity some of the risk from underlying items. Examples of underlying items include:

   (a) a share in a pool of assets (notional or actual);

   (b) an interest return on an explicit account balance (ie a nominal amount); and

   (c) a share in the performance of a pool of insurance contracts.

2. In other words, the defining feature of a contract with a participating feature is that the contract provides the policyholder with an investment return that varies with the overall returns on the underlying items. This means that the policyholder bears some of the investment risk. For contracts with no participating features, the entity bears all of the investment risk.

3. This paper discusses whether adaptations for contracts with participating features are needed to be made to the IASB's previous decisions for contracts with no participating features and if so, what those adaptations are.

4. The paper describes:

   (a) what the IASB's tentative decisions for contracts with no participating features are; and

   (b) the adaptations that the IASB could consider for contracts with participating features, including:

      (i) the adaptations that the IASB proposed in the 2013 Exposure Draft *Insurance Contracts* (2013 ED); and

      (ii) the alternative adaptations proposed in the comment letters.

5. This paper includes limited discussion of the mirroring exception proposed in the 2013 ED for a narrow set of contracts with participating features. Instead, the paper focuses on possible adaptations to the general model developed by the IASB. The staff plan to consider at a later stage whether an exception such as the mirroring exception would still be needed.

6. This paper does not ask the IASB for decisions. The staff intend to ask for decisions on contracts with participating features at a future meeting. This paper should be read in conjunction with Agenda Paper 2A *Background on contracts with participating features.*

Structure of the paper

7. The analysis in this paper considers the general model developed by the IASB to date, and considers the adaptations that might be needed for contracts with participating features in respect of the following:

   (a) measuring the fulfilment cash flows (paragraphs 8-20);

   (b) measuring the contractual service margin (paragraphs 21-49);

   (c) recognising changes in estimates (paragraphs 50-77); and

   (d) presentation in the statement of comprehensive income (paragraphs 78-98).

Measuring the fulfilment cash flows

8. The 2013 ED proposes that the measurement of a contract with participating features is the present value of the fulfilment cash flows determined using a discount rate that reflects the characteristics of those cash flows. At initial recognition and subsequently, the fulfilment cash flows are defined as an explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment. The underlying objective of this approach is to achieve a valuation of the insurance contract, including any options and guarantees embedded in the insurance contract, in a manner that is consistent with market information.

9. The 2013 ED did not propose particular adaptations for the fulfilment cash flows in contracts with participating features, but provided application guidance on how to apply the principles in the general model to contracts with participating features. This section discusses that application guidance, as follows:

   (a) cash flows (paragraphs 10-12);

   (b) discount rate (paragraph 13);

   (c) risk adjustment (paragraph 14); and

   (d) the interaction between the cash flows and the discount rate (paragraphs 15-20).

Cash flows

10. For contracts with participating features, the cash flows that arise as the entity fulfils the contract include the following:

    (a) cash flows that vary with returns on underlying items, either directly or indirectly. These are cash flows that provide the policyholder with a return on underlying items. These cash flows include:

        (i) cash flows that arise because of a direct correlation between the returns on underlying items and the returns to

policyholders (ie the cash flows vary directly with returns on underlying items); and

(ii) cash flows that vary with returns on underlying items only when the returns from the underlying items exceed the floor (ie the cash flows vary, but indirectly with the returns on underlying items).

The 2013 ED referred to the cash flows that vary directly and indirectly with returns on underlying items. This paper uses the term 'cash flows that vary with returns on underlying items' to include both those that vary directly or indirectly. Such cash flows arise only in contracts that have participating features.

(b) cash flows that do not vary with the returns on underlying items. These cash flows arise when the amount paid to the policyholder does not change because there is a change in the performance of the pool of underlying items. Such cash flows include:

(i) claims handling costs (ie the costs that the entity will incur in processing and resolving claims) and other expenses. Such cash flows also arise in contracts that have no participating features.

(ii) fixed amounts that would be paid out on the occurrence of an insured event. The 2013 ED termed these 'cash flows that do not vary with underlying items'. Such cash flows also arise in contracts that have no participating features.

(iii) a fixed amount paid in all scenarios (ie a floor). For example, some insurance contracts contain embedded guarantees (for example, a guarantee that promises a minimum investment return). Such cash flows arise in some contracts that have participating features and contracts that have no participating features (for example, endowments).

11. Consistent with the principle that the measurement of the insurance contract includes all the cash flows that arise as the entity fulfils the contract, the 2013 ED provided application guidance that the cash flows used to measure the contract include:

(a) cash flows that will result from options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 10(a) of the 2013 ED). The 2013 ED also clarified that when insurance contracts contain embedded options or guarantees, it is important to consider the full range of scenarios (see paragraph B66(f) of the 2013 ED).

(b) payments arising from existing contracts that provide policyholders with a share in the returns on underlying items (see paragraph 33 of the 2013 ED), regardless of whether those payments are made to current or future policyholders (see paragraph B66(k) of the 2013 ED).

12. The 2013 ED also clarified that the cash flows used to measure the insurance contract exclude investment returns on underlying items. The investments are recognised, measured and presented separately. However, if any cash flows of the insurance contract depend on the investment returns, the measurement of that insurance contract may be affected (see paragraph B67(a) of the 2013 ED).

Discount rate

13. The 2013 ED did not propose any adaptations to the principle that estimates of discount rates should be consistent with other estimates that are used to measure the insurance contract in order to avoid double counting or omissions. However, it clarified that the characteristics of the insurance contract should reflect the extent of dependence of the amount, timing or uncertainty of the cash flows that arise from the insurance contract on the returns on underlying items. The discount rate used to measure those cash flows shall therefore reflect the extent of that dependence. Paragraphs 15-20 describe the concerns that were raised because of the way the 2013 ED described how this principle could be implemented.

Risk adjustment

14. The 2013 ED did not propose any adaptations for contracts with participating features with respect to the risk adjustment, and the staff believes that none are needed.

Overall measurement of fulfilment cash flows: interaction between the cash flows and the discount rate

15. The 2013 ED described one way of achieving the objective of the 2013 ED by measuring the fulfilment cash flows by dividing the cash flows of the contract and applying different discount rates, as follows:

    (a) For cash flows that vary with underlying items, the underlying items are likely to include assets (perhaps exclusively). Thus, the appropriate discount rate is the rate that reflects the extent of that dependence with the assets. Hence, the rate is likely to include asset risk that is shared with the policyholder.

    (b) For cash flows that do not vary with underlying items, the policyholder does not share in the asset risk. Thus, the appropriate discount rate should not include any asset risk. Therefore, it is likely that this would be a lower discount rate than the rate applied for the cash flows in (a).

16. In other words, the approach in the 2013 ED seeks to value the insurance contract, including any guarantees embedded in the insurance contract, in a manner that is consistent with market information by placing weight on the appropriate discount rate for each set of cash flows.

17. For example, a guarantee of fixed amount on death (for example, CU100,000[1]) could be embedded in a contract with participating features. The same guarantee could also be embedded in a contract with no participating features. The IASB's objective was that there would be consistent measurement of the fulfilment cash flows of that guarantee regardless of the contract that the guarantee was embedded in. Because the guarantee does not vary with underlying items, the appropriate discount rate is the discount rate that is not asset dependent. However, if the entity applied a discount rate that reflected the dependence of the cash flows of the guarantee on the underlying assets (Discount 1), the probability-weighted estimate of cash flows of the guarantee would be lower than that determined using a discount rate that has no dependence on the assets (Discount 2). Consequently, if the entity applied Discount 1 to the fulfilment cash flows of the guarantee, the

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

entity would need to do further adjustments in the valuation so that the guarantee is measured appropriately to increase the estimate of the liability.

18. The 2013 ED's objective could be achieved with a "real-world" and "risk-neutral" approach for valuing the insurance contract.[2] However, some interpreted the 2013 ED as precluding use of one of these two approaches.

19. Many constituents thought that the 2013 ED was too prescriptive in specifying the use of the divide and measure the cash flows approach, which was discussed in paragraph 15, to achieve the objective of market-consistent valuation. They note that there are other actuarial techniques to value a contract when the cash flows behave differently in various scenarios. They also thought that the approach would be too complex because:

    (a) entities' systems typically use a single yield curve to discount all the cash flows of the portfolio of contracts. A single yield curve can achieve the objective of market consistent valuation if:

        (i) An appropriate yield curve is chosen that reflects the characteristics of all the cash flows; and

        (ii) An illiquid risk-free yield curve is applied to cash flow scenarios in which the probabilities of future outcomes are adjusted for risk (ie a "risk-neutral" approach).

    (b) for valuing a minimum guarantee as described in paragraph 15, there would need to be a different division of cash flows every time there was a change to the guarantee. For example, some products provide a minimum amount that can be withdrawn at maturity or death and that minimum amount increases over the life the product.

20. The staff agrees that the IASB's objective could be met using actuarial techniques that use a single yield curve to estimate fulfilment cash flows, even when the

[2] Risk-neutral scenarios use probabilities of future outcomes that are adjusted for risk, and the probability-weighted cash flows are then discounted using the risk-free rate. Real-world scenarios use probabilities of future outcomes that are not adjusted for risk, and the probability-weighted cash flows are then discounted using a discount rate that includes the risk premia that market participants require for bearing risk. In other words, risk is reflected for risk-neutral scenarios within the probabilities, and for real-world scenarios within the discount rate. Both approaches can be used for the market-consistent valuation of assets and liabilities, if care is taken to reflect the risk premia that market participants require.

contract includes both cash flows that vary and those that do not with underlying items. However, the staff thinks that dividing the cash flows into cash flows that vary, and those that do not, with underlying items and applying appropriate discount rates to each may still be needed to provide consistency in:

(a) the measurement of the contractual service margin, and therefore, of the total liability. The discount rate affects the amount of interest accreted on the margin and the amounts that adjust margin (which are determined on a present value basis). The staff plan to consider at a future meeting the discount rate that should be applied when accreting and adjusting the margin.

(b) the presentation of interest expense. When an entity chooses to present the effects of discount rate changes in OCI, the discount rate affects the amounts recognised in other comprehensive income (OCI) and profit or loss. This is discussed further in paragraphs 85-97.

Question 1— Measuring the fulfilment cash flows
Do you have any comments or questions on the staff's analysis about the measurement of the fulfilment cash flows?

Measuring the contractual service margin

21. This section discusses, for the contractual service margin:

(a) the adaptions that the IASB proposed in the 2013 ED for contracts with participating features in paragraphs 23-26;

(b) an alternative proposal for adaptations for contracts with participating features, which include proposals relating to:

(i) the entity's share in the underlying items in paragraphs 27-44;

(ii) the recognition of the margin in profit or loss in paragraphs 45-48; and

(c) further adaptations that may be needed in paragraphs 49-22.

22. The other sections of the paper also discusses whether the margin should be adjusted for:

    (a) changes in estimates of investment returns that result in changes in the amounts paid to policyholder (paragraphs 50-56); and

    (b) changes in options and guarantees (paragraphs 57-77).

The adaptations that the IASB proposed in the 2013 ED

23. Contracts with participating features are predominantly investment contracts that oblige the entity to provide asset management services in addition to insurance coverage. The IASB's tentative decisions on unbundling goods and services mean that some of these asset management services would not be unbundled because they are integrated with the insurance coverage.

24. The 2013 ED acknowledged that the services in a contract with participating features include insurance coverage and asset management and, as a result, the 2013 ED required that an entity recognise the margin in profit or loss in the pattern of transfer of "coverage and other services". It was envisaged that "other services" would encompass asset management services. The IASB has previously concluded that a reasonable pattern of profit recognition for asset management services would be one that tracks the build-up of the assets over time.

25. Because the margin is a blend of insurance coverage and asset management services that are not separately identifiable, any recognition pattern for the contractual service margin is inevitably arbitrary, at least to some extent. The staff thinks that to apply the requirement that an entity recognises the margin in profit or loss in the pattern of transfer of coverage or other services:

    (a) the entity would choose the predominant driver that best reflects the pattern of transfer of the combined coverage and asset management services and then recognise the margin in profit or loss over the coverage period. A profit driver based on assets under management may be appropriate when the principal service provided is investment management.

(b) depending on the contract, it may be appropriate to change the profit driver from asset management services to insurance coverage (or vice versa) over time. For example, in a product with a guaranteed annuity option, the entity provides asset management service prior to the option being exercised and insurance coverage after the option is exercised.

26. Contracts that provide asset management service also provide an investment return. The proposals in the 2013 ED reflect the IASB's view that the provision of investment returns to the policyholder is not a service. Instead it is a financial return. Thus, because the IASB views the contractual service margin as the unearned profit from the contract that would be earned from providing services under the contract, the contractual service margin would not be recognised in profit or loss in a pattern that reflects expected investment returns or expected realisation of investment returns. The 2013 ED further clarified that:

(a) the contractual service margin is not adjusted for changes in estimates of cash flows that depend on investment returns if those changes arise as a result of changes in the value of the underlying items. Such changes do not relate to services provided under the contract. That means that an entity does not adjust the margin by changes to the estimates of payments to policyholders (see paragraph B68(d) of the 2013 ED).

(b) the contractual service margin is adjusted for changes in estimates of cash flows that are expected to vary directly with returns on underlying items only if those cash flows relate to future services under the insurance contract. For example, changes in cash flows due to the effect of changes in explicit asset management fees relate to future services under the insurance contract. Gains or losses on the underlying items do not relate to unearned profit from future services from the insurance contract and are recognised in accordance with the Standards relevant to the underlying items.

Alternative adaptations proposed

27. In the comment letters to the 2013 ED, some preparers suggested an alternative proposal for the measurement of the contractual service, which is discussed in the paragraphs below ('the alternative proposal').

28. The alternative proposal reflects a difference in view between its proponents and the view in the 2013 ED, as follows:

    (a) the IASB views the contractual service margin as the unearned profit from the contract that would be earned from providing services under the contract. In effect the IASB's view regards the contractual service margin as the representation of an obligation measured at the amount of profit that the entity expects to receive for fulfilling the obligation. The IASB does not view the provision of investment returns as a service.

    (b) The proponents of the alternative proposal view the margin as unearned profit for the entity arising from the insurance contract. They view the performance of the underlying items as integral to the overall performance of the contract. Consequently, the margin on Day 2 should represent unearned profit that includes any gains and losses from the underlying items recognised in accordance with other Standards that they believe have not yet been earned. Proponents of the alternative proposal regard the provision of investment returns as a service.

29. Are these two views different? On Day 1, the two views have the same effect. However, this difference in views would result in different effects on Day 2 in two important aspects:

    (a) the treatment of the entity's share of returns on the underlying items:

        (i) In the 2013 ED proposals, the margin is adjusted for gains and losses that relate to future service within the boundaries of the contract's cash flows.

        (ii) In the alternative proposal, the margin is adjusted for gains and losses arising from the changes in entity's share of the underlying items (for example, assets, experience) to which

the participating contract is linked. This is discussed further in paragraphs 27-44.

(b) the recognition of the contractual service margin in profit or loss

(i) In the 2013 ED proposals, the margin is earned according to the pattern of insurance coverage or other service (for example, asset management service).

(ii) in the alternative proposal, for some contracts the margin is earned when profits from the insurance contract are considered attributable to the entity, as described in paragraph 30.

30. Paragraph 29(b)(ii) described the recognition of the margin in profit or loss under the alternative proposal as being earned when profits from the insurance contact are considered to be attributable to the entity. Under this proposal, the profit driver for the services provided would depend on both the contractual features of the contract and the regulatory environment:

(a) in some contracts, there is a contractual or regulatory performance-sharing mechanism. In such cases, the recognition of the margin in profit or loss would be consistent with the performance-sharing mechanism between the policyholder and the entity. Proponents of the alternative proposal believe that the entity's share of profits arises when amounts are attributed to the policyholder (ie when bonuses are declared or amounts are credited to the policyholder's account). They believe that the entity's share that relates to such amounts represents the earned profit from providing services under the contract. In general, the performance-sharing mechanisms between policyholders and the entity:

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

(ii) are capable of increasing the value of the guarantees written by the entity to the policyholder; and

(iii) may be constrained by regulation or competitive forces, or both, to differing extents.

This is discussed further in paragraphs 31-44.

(b) in some cases, the contract provides only a fee to the entity. In such cases, the recognition pattern is based on the fees charged in the period. This is discussed further in paragraphs 45-48.

31. For contracts that have a contractual or regulatory performance-sharing mechanism, the alternative proposal contains two variations for determining the amount of the margin to be recognised in profit or loss in the period. Both variants are intended to ensure that the carrying value of the margin represents the profits from the contract that are not yet considered attributable to the entity (for example, the value of future bonuses to the entity). The amount recognised in each period would reflect the change in those amounts (for example, the change in the value of bonuses), because the proponents of the alternative proposal regard the provision of such amounts as the service provided under the insurance contract in the period. Assuming no guarantees and options, the two variations proposed 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 profit that is considered to have become attributable in the period and the carrying value of the margin represents the value of future attributable profits. This method is consistent with an approach currently used in some jurisdictions in which the amount recognised in profit or loss is the bonus declared to the entity in that period, and the value of future bonuses is treated as part of the liability.

(b) **Variation 2**: the carrying value of the margin at the end of the period is measured directly by calculating the present value of the entity's share of future attributable profits. Consequently, the amount of contractual service margin recognised in each is the difference between the previous carrying value of the margin and the directly determined present value of entity's share of future attributable profits.

32. The following simplified example illustrates the alternative proposal and these differences for a simplified discretionary 90/10-style participating contract. The assumptions are simplified to illustrate how the gains or losses potentially attributable to the entity would adjust the margin. The example also ignores options and guarantees.

Example 1: alternative proposal

A portfolio of contracts with participating features was written at the beginning of the year, in which:

- the entity received premiums totalled CU1,000, which was used to purchase assets;
- the policyholder participates in 90% and the entity 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:

- the entity attributes profits by declaring a bonus of CU45 to the policyholders and CU5 represents the entity's share (total bonuses declared are CU50); and [3,4]
- the underlying assets have grown to CU1,100 (an increase of CU100).

As a simplifying assumption, the amounts recognised in profit or loss for the change in the insurance liability is CU90 (90% X 100[increase in the value of the assets]) and this is the same under both the 2013 ED and alternative proposal.

Under the 2013 ED proposal:

- The margin recognised in profit or loss in line with services is CU7 (assumption).
- The net profit is a sum of the investment margin for the period and the recognition of the margin in profit or loss.
- The liability at the end of the year is CU1,083 which represents all the performance obligation of the contract. This comprises the fulfilment cash flows of CU990 (CU900+CU90) and the margin of CU93 (CU100-CU7). CU93 represents the performance obligation for services to be provided.

The profit or loss for the period would be as follows (ignoring the accretion of

[3] 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.

[4] For some contracts, the performance-sharing mechanism would determine the ratio of entity to policyholder bonuses. For other contracts, the entity may have some or full discretion on determining that ratio.

interest on the margin):

	ED proposal	Alternative proposal
Insurance contract revenue	7	5
Investment income	100	100
Interest expense	(90)	(90)
Net investment margin	10	10
Remeasurement of the margin		(10)
Net profit	17	5
	The liability recognised on the balance sheet is:	
Liability	1,083	1,095

Under the alternative proposal:

- Gains/losses potentially attributable to the entity of CU10 (CU100[Investment income]–CU90[Policyholder's share in investment income recognised in profit or loss)) would be adjusted against the margin.
- CU5 of the margin would be recognised in profit or loss, representing the entity's view of the services provided in the period. This example assumes that the shareholder's bonus represents the services provided in the period.
- As a consequence, net profit considering both the underlying items and the liability is CU5, which represents the entity's view of the services provided in the period.
- The liability at the end of the year is CU1,095. This is comprised of the fulfilment cash flows of CU990 (CU900+CU90) and the margin of CU105 (CU100+CU10-CU5).

33. In effect:

(a) **For the entity's share:** the alternative proposal reflects the view that the entity does not earn investment gains and losses in the period. Accordingly, the proposal would adjust the contractual service margin for the entity's share of the investment income or losses arising from the underlying items that are recognised in profit or loss. For example, the proposals would mean:

(i) For debt instruments accounted for at Fair value through OCI (FVOCI), the impairment losses and interest revenue recognised in profit or loss would adjust the margin. However, the fair value gains and losses recognised in OCI would not adjust the margin.

(ii) For assets accounted for at fair value through profit or loss (FVPL), the fair value gains and losses would adjust the margin.

(In Example 1, the gain of CU10 potentially attributable to the entity is treated as an adjustment to the margin.) Paragraphs 34-44 discuss the arguments for and against this approach further.

(b) **For the recognition of the margin in profit or loss:** the alternative proposal applies a driver to recognise the margin in profit or loss in a way that reflects the profits are attributable to policyholders (for example, that reflects the declared bonuses). In example 1, the driver for the recognition of the margin in profit or loss is the entity's share in declared bonuses. The recognition of the margin in profit or loss is determined so that it achieves a net profit recognised that is equal to the CU5 that the entity regards as earned for the services provided in the period. Paragraphs 45-48 set out the arguments for and against this approach for recognition of the margin.

Should the margin be adjusted with changes in the entity's expected profit from the underlying items?

34. Reasons given by supporters of the proposal to adjust the contractual service margin by changes in estimates of the entity's expected profit from the underlying items are:

(a) the entity's share in the performance of the underlying items provides one of the sources of profits for the participating business. In other words, one of the sources of profit is the spread difference between the performance of the underlying items and the performance promised to the policyholder.

(b) the entity's share in the performance of the underlying items is akin to an implicit asset management fee. Changes in the effect of explicit asset management fees related to future services would adjust the margin according to the proposals in the 2013 ED.

(c) some note that adjusting the margin for the entity's expected profit from underlying items would result in a net profit or loss that would be the same regardless whether the changes in discount rates are recognised in profit or loss or OCI. Accordingly, they suggest that it would not be necessary to require/permit the use of other comprehensive income for the recognition of the effects of changes in market variables (or other items).

35. However, arguments against adjusting the contractual service margin by changes in estimates of the entity's expected profit from the underlying items are as follows:

(a) It would be inconsistent with the approach for contracts with no participating features (see paragraph 36);

(b) It would be inconsistent with other IFRS (for example, IFRS 9 *Financial Instruments* (IFRS 9)) (see paragraph 37);

(c) It would require the identification of the underlying items (see paragraphs 38-41); and

(d) It may have similar disadvantages to those reported in the comment letters relating to the mirroring exception (see paragraphs 42-44).

These arguments are discussed below.

Consistency with contracts with no participating features

36. Some disagree that the margin should be adjusted to reflect the changes in entity's share of the underlying items on the grounds that this is a source of profits for contracts with participating features. This is because the investment returns on underlying items acquired with premiums from an insurance contract are also a source of profit for the entity in some, if not all, of non-participating insurance contracts. The only difference is that the policyholder is promised an obligation

that does not vary with the performance of the underlying items. Consequently, treating the investment returns arising from assets that back contracts with participating features differently from returns arising from assets that back contracts with no participating features could be regarded creating an arbitrary difference in the way insurance contracts are accounted for. Those that hold this view do not see the changes in entity's share of the underlying items as an implicit asset management fee.

Consistency with other IFRSs

37. Some disagree that the margin should be adjusted to reflect the changes in entity's share of the underlying items because they view the proposals to be inconsistent with the requirements of other IFRSs. They note that the entity's share in the performance of the underlying items is a consequence of the entity controlling the underlying items and having to recognise those underlying items in the balance sheet and profit or loss in accordance with IFRSs. Consequently, they think it is inconsistent with IFRSs to change the timing of when these income and expenses of the underlying items are recognised in profit or loss so that they would be significantly different from how such underlying items would be accounted for if they did not back insurance contracts with participating features. They note that such inconsistencies increases structuring opportunities and, therefore, may reduce the transparency of the results between economically similar transactions.

Need to identify underlying items

38. Some note that a fundamental difficulty with the proposal to adjust the margin to reflect the entity's share of the underlying items is that it would require the IASB to specify which underlying items would qualify. However, identifying such criteria would be difficult, because :

    (a) in some cases, there is a clear linkage between the returns to policyholders and the underlying items. This is the case when the contract or regulation specifies that the entity must hold the specified underlying item and when the contracts permits the entity no discretion over the amount and timing of the returns passed to the policyholder. An example of a contract in which there is clear linkage is a unit-linked

contract with a legally segregated fund of assets. For most of these contracts the entity will charge an explicit fee. Some entities also hold a share in the underlying items in the form of units of those funds. How should the entity's direct holding of the units be treated?

(b) in some jurisdictions, the regulation or law requires the underlying items for some contracts to be held separately from the rest of the entity's assets and liabilities. However, there are variations in the performance-sharing mechanism. The entity may be obliged to pass on a specified return or may have some or full discretion on the amount and/or timing of the returns passed to the policyholder. It can be difficult to identify when cash flows reflect a share in underlying items, rather than a payment made at the entity's discretion that does not reflect a share in the underlying items.

(c) for some contracts, the designation of underlying items may exist only for internal management purposes. This could create the following difficulties:

  (i) the entity may change those designations for various reasons.

  (ii) the underlying items may not be clearly identified for a specific portfolio because the entity may have several portfolios that relate to the same underlying items.

(d) the entity could promise a return based on a specific type of underlying items and could choose to invest the premiums in money collected that was not solely in specified type of underlying items. For example, an entity could promise a return based on the performance of a share index and choose to invest the premiums in a combination of bonds and derivatives. It is unclear what the underlying items are in this case.

(e) there may be no assets designated but the policyholder could be provided with an interest-like return in the form of a crediting rate. The crediting rate would generally reflect the entity's overall performance and expectations. However, it could be unclear what the underlying items are.

39. The difficulty in specifying underlying items was also illustrated in the response to the proposed mirroring exception in the 2013 ED. The mirroring exception applied only to contracts with participating features for which there could be no possibility of an economic mismatch between the returns on underlying items and payments to the policyholder. The 2013 ED proposed that, to qualify for this exception to the general model, an entity must hold underlying items and the contract must specify a link between the payments to the policyholder and the returns on those underlying items. Many disagreed with the scope of the proposals but for various reasons:

    (a) Some would have restricted the scope further to where there was also a contractual link to specified amounts paid to the policyholder because they thought that the proposals were too difficult to be applied to contracts in which there are discretionary payments.

    (b) Some believed that a separate model for contracts with participating features was warranted, and that the separate model should encompass all contracts with participating features regardless of whether the entity is required to hold specified assets or the amounts returned to the policyholder contain some, or full, discretion. However they did not necessarily agree that the mirroring exception was the right approach.

40. The staff also note that the difficulty in specifying the underlying items was one of the considerations in the staff recommendation for an accounting policy option for presenting the effects of discount rate changes in profit or loss or other comprehensive income instead of specified criteria related to the assets backing the portfolio of contracts. In the feedback on providing an option of the proposals, entities noted that some assets are not specifically designated to portfolios, but are held in case the assets that are designated to a specific portfolio are insufficient to pay the policyholder's claims and benefits. Consequently, some think it is inherently arbitrary to designate assets to a specific portfolio unless the contract promises the policyholder **only** the performance of the specific assets in all scenarios (ie there are no options and guarantees). These contracts are likely not to exist in the population of the existing insurance contracts.

41. If the IASB concluded that the challenges of identifying underlying items could be overcome, it would also need to consider the following issues:

    (a) Would there be a need to mitigate any structuring opportunities between contracts that qualify and those that do not? The significance of such opportunities would increase with the degree of difference between the proposals for contracts with participating features from the proposals for contracts with no participating features. It could be possible to address this issue using strict and objective criteria for determining which contracts should be accounted for as having participating features.

    (b) Would there be a need to mitigate any complexity for entities that do not identify underlying items in the way specified?

Relevant feedback from the mirroring exception

42. There are similarities between the alternative proposal and the mirroring exception because the insurance liability could comprise components measured using a combination of different accounting bases:

    (a) under the mirroring exception, the component is the fulfilment cash flows.

    (b) under the alternative proposal, the component is the margin.

43. Accordingly, the staff note this criticism of the mirroring exception, ie that requiring a component of the liability to be measured as a combination of different accounting bases would not provide a faithful representation of the contract and may not be understandable to users, could also apply to the alternative proposal. Under the alternative proposal, the margin would be measured as a total of the amounts measured using different measurement basis (for example, fulfilment cash flows, amortised cost, fair value gains or losses).

44. In addition, the implementation of the mirroring exception requires entities to track the amounts reported in the statement of comprehensive income (and the balance sheet) that are related to the underlying items so that the relevant amounts

for the liability could be determined. Some have told us that this would be too difficult. This complexity also applies to the alternative proposal.

Question 2—Entity's share of underlying items

Do you have any comments or questions on the staff's analysis of the need for adaptations to account for the entity's share of underlying items?

In particular, do you have any comments or questions on the feasibility of identifying underlying items for contracts with participating features?

How should the margin be recognised in profit or loss?

45. Those in favour of recognising the contractual service margin in profit or loss according to the profits attributable to the entity argue that such profits are the best indication of the pattern of services provided:

(a) for contracts with performance-sharing mechanisms, proponents of this view regard the provision of service to be the amounts paid under the performance-sharing mechanism.

(b) for fee-based contracts, proponents of this view believe that the explicit fee should be most indicative of the service provided.

46. However those who disagree that the contractual service margin should be recognised according to the profits attributable to the entity argue that such an approach may **not** be indicative of the pattern of services provided[5]. For example, the amounts paid under the performance-sharing mechanism would not be indicative of the pattern of services provided when:

(a) the amounts attributed to policyholders are based on the timing of the realisation of the underlying items (for example, when interest is received from a bond). For example, in some cases a bonus is paid when the underlying item is sold. However, the service that the entity has provided is the asset management services of investing the policyholder's fund appropriately and rebalancing the investments

[5] The staff notes that 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 the contract.

when needed. Such asset management services would be provided throughout the contract and not simply on the sale of the assets.

(b) most of the asset returns are attributed on maturity of the contract. This would result in a greater recognition of the margin in profit or loss at the end of the contract, even though the policyholder benefits from the asset management and insurance services throughout the life of the contract.

(c) when there are significant differences between the basis used for the performance-sharing mechanism and IFRS. For example, the performance-sharing mechanism calculates the amounts to be attributed using national GAAP requirements or according to solvency requirements.

47. Similarly, the pattern of charged explicit fees may not reflect the service provided in the period. This is the case when the fees do not follow the pattern of asset accumulation. For example, some contracts have explicit fees that are stepped (a different percentage or fee amount is charge in different periods). However, regardless of the pattern of fees charged, the same asset management services would be provided by the contract.

48. Thus the staff believe that recognising the contractual service margin in accordance with the amount attributable to the entity would not necessarily reflect the service provided under the contract. The staff think that a reasonable pattern for the recognition of the margin in profit or loss would reflect:

(a) that the provision of services (for example, the asset management services and the insurance coverage) occurs over the life of the contract; and

(b) that the total margin must be recognised in profit or loss in a reasonable, systematic way (for example, in the pattern of the build-up of the underlying assets on a fair value basis).

Question 3–Recognition of the margin in profit or loss

Do you have any comments or questions on the staff's analysis of the appropriate recognition pattern for the contractual service margin for contracts with participating features?

Further adaptations that may be needed

49. Staff note that, depending on the IASB's decisions on contracts with participating features on the margin (discussed in paragraphs 27-44), the IASB may need to consider whether further adaptions are needed relating to the following tentative decisions:

    (a) that, once the margin is exhausted, further changes in estimates of cash flows are recognised in profit or loss;

    (b) that favourable changes in estimates that arise after losses were previously recognised in profit or loss should be recognised in profit or loss to the extent that they reverse losses that relate to coverage and other services in the future;

    (c) that interest should be accretion interest on the margin; and

    (d) on the appropriate discount rate used to accrete and adjust the margin.

Changes in estimates

Where should changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items be recognised?

The adaptations the IASB proposed in the 2013 ED

50. The 2013 ED proposed that changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items should be recognised in profit or loss. This is consistent with the recognition of changes in estimates of cash flows for financial instruments. For example, changes in estimates in

prepayment options for assets measured using amortised cost are recognised in profit or loss.

51. Feedback on this proposal was mixed:

    (a) a few recommended that all cash flows should be treated consistently and consequently, they believe that all changes in estimates should adjust the margin. This is discussed in paragraphs 53-54.

    (b) when the underlying items are measured at fair value through profit or loss, some supported the 2013 ED proposals to recognise the equivalent changes in the liability in profit or loss.

    (c) when the entity presents the effects of changes in discount rate in OCI, some thought that it would be more useful to recognise the equivalent changes in the liability in OCI. This is discussed in paragraphs 55-56.

52. Staff notes the difference between recognising changes in estimates as an adjustment to the margin, and recognising such changes in the statement of comprehensive income (ie profit or loss or OCI) is a difference in measurement and not presentation. This is because:

    (a) recognising the margin (as long as it is not zero) is that the total liability, and therefore, equity would **not** change in value before and after change.

    (b) recognising in the statement of comprehensive income (SCI), the total liability, and therefore equity, would change in value before and after the change.

Margin

53. Some note that it would be simpler to recognise changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items in a way that is consistent with the changes in estimates of other cash flows. However, an argument against that proposal is that cash flows relating to the returns on underlying items do not represent a change in the profitability of the contract. For example, assume that the policyholder has a 100% of share in a known pool of assets. A change in the cash out flows due to changes in the

performance of the assets represents a change in the entity's obligation to pay out cash flows from the performance of the assets, rather than changes in estimates that relate to future services.

54. Furthermore, if those changes adjust the margin, this may result in less useful financial information because it may create an accounting mismatch between the returns the entity receives from the underlying items, and the amounts that the entity pays the policyholder. The following simplified example illustrates this issue when the underlying assets are measured at fair value through profit or loss and the contract provides the policyholder with 100% of the return of the underlying items:

> **Example 2 Changes in estimates of the returns on underlying items**
>
> At inception, the premium received is CU1,000. The entity uses CU950 to purchase a pool of assets and the fair value of the assets at inception is CU950 (assuming no transaction costs). The policyholder is promised 100% of the fair value of the assets on surrender or maturity. The margin at inception is CU50 (CU1,000-CU950).
>
> After a year, the fair value of the pool of assets has decreased by CU7 from CU950 to CU943. Hence, the present value of fulfilment cash flows would also decrease by CU7.
>
> To avoid accounting mismatch, the change in the present value of the fulfilment cash flows would be reported in the same way as the change in the fair value of the pool of assets. Consequently, the change in the present value of fulfilment cash flows should be reported in profit or loss consistent with fair value change in the assets with the following effect.
>
> | | |
> |---|---|
> | Fair value loss on assets | (CU7) |
> | Gain on the liability | CU7 |
>
> If the decrease in the fulfilment cash flows is recognised in the margin, an accounting mismatch would exist in profit or loss and on the balance sheet (because the total liability would remain at CU1,000 whereas the assets have changed to CU943).

Statement of comprehensive income

55. Some think that whether changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items are recognised in profit or

loss should be consistent with how the entity applies the accounting policy choice to present discount rate changes in profit or loss or OCI. (This assumes that the IASB will confirm that effects of discount rate can be recognised in OCI and extend the accounting policy option to contracts with participating features. This is discussed further in paragraph 79-84).

56. Some observe:

(a) if the entity chooses to present the effects of changes in discount rates in profit or loss, recognising changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items would mean that the entity would present all the effects of changes in market variables in profit or loss (ie both changes in discount rate and estimates of cash flows). Presenting such changes in profit or loss would also be consistent with the recognition of changes in cash flows for financial assets.

(b) if the entity chooses to present the effects of changes in discount rates in OCI, recognising changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items would allow consistency of recognition of changes caused by market variables. They argue that this would result in more useful information.

Question 4—Changes in estimates of investment returns that affect the amount paid to the policyholder
Do you have any comments or questions on the staff's analysis of the treatment of changes in estimates of investment returns that affect the amount paid to the policyholder?

Where should changes in the value of the options and guarantees be recognised?

57. When the policyholder receives 100% of the returns from underlying items, the appropriate accounting treatment for changes in returns from underlying assets is relatively straight-forward—most agree that changes in the liability should be

recognised in the same location as the underlying items. However, in most cases, contracts with participating features contain other features that will need to be accounted for—options and guarantees. Options and guarantees embedded in insurance contracts include, but are not limited to, derivatives as defined in IFRS. Some examples of those options and guarantees are included in Agenda paper 2A.

58. This section discusses:

(a) the 2013 ED proposal and the feedback received in paragraphs 59-61;

(b) the components of an option and guarantee in paragraphs 62-68; and

(c) the alternatives for presenting options and guarantees in either the margin or SCI in paragraphs 69-77.

2013 ED proposal

59. The 2013 ED proposed that:

(a) for contracts to which the entity applied the mirroring exception, changes in the fulfilment cash flows that are expected to vary indirectly with returns on underlying items would be recognised in profit or loss. Such cash flows would include those arising from the effect of market variables on the value of options and guarantees.

(b) for contracts to which the entity did not apply the mirroring exception, the 2013 ED did not have specific requirements on where the value of the cash flows that are expected to vary indirectly with returns on underlying items would be recognised. However, changes arising from changes in market variables would be recognised in the statement of comprehensive income: changes in estimates of the returns on underlying items would be recognised in profit or loss, and the effects of changes of discount rates would be recognised in OCI.

Feedback on the proposal to recognise options and guarantees in profit or loss under the mirroring exception

60. Some agreed with recognising options and guarantees in profit or loss because:

(a) this would reduce an accounting mismatch when an entity economically hedges those options and guarantees with derivative instruments; and

(b) the approach would be consistent with the treatment of derivatives in IFRS 9.

61. However, many disagreed with recognising options and guarantees in profit or loss because this was inconsistent with the proposals for contracts that did not apply the mirroring exception. They think that the IASB's decision that it would not separate these derivatives and account for them in accordance with IFRS 9 means that consistency with IFRS 9 should not be a primary driver. Instead:

(a) Some think that there should be no separate requirements for options and guarantees consistent with contracts to which the entity did not apply the mirroring exception (discussed in paragraph 59(b)). Consequently, there would be no need to separately recognise or present the valuation of options and guarantees from the determination of the fulfilment cash flows.

(b) Some recommend that the proposals should be modified. However, these respondents had different views on whether the options and guarantees should instead be recognised in the margin or OCI (discussed in paragraphs 62-77).

What do we mean by changes in the value of options and guarantees?

62. The 2013 ED did not contain specific proposals for options and guarantees. However it envisaged that most of the cash flows arising from options and guarantees would be cash flows that varied indirectly with the returns on underlying items.

63. In practice, the phrase 'options and guarantees' is often used to refer to contractual features that produce pay-offs in some scenarios but not in others. These pay-offs include those that occur and those that do not occur on an insured event. An example is a guarantee of a specified minimum return to the policyholder, for example a guarantee of an annual return of at least 3% that is payable on death or at maturity. Guaranteed returns of this kind often provide

pay-off patterns that resemble those provided by explicit options, and are often valued using similar techniques.

64. There are two components in the valuation of options, which are:

    (a) Intrinsic Value—the difference between the market value of the underlying and the strike price; and

    (b) Time Value—the present value of the difference between the market value of the underlying and the strike price in the future when the option is exercised.

65. When discussing whether the options and guarantees should be recognised in profit or loss, OCI or the margin, some respondents are **only** referring to the 'time value of options and guarantees'[6].

66. This may reflect that the time value of option and guarantees concept is part of one approach of the Embedded Value (EV) reporting framework. Some life insurers in some parts of the world report embedded value information, generally as supplementary, unaudited information outside the financial statements. Embedded value approaches have been largely unregulated and, as a result, there has been diversity in their application. In particular, some do **not** include a valuation of options and guarantees consistent with market information in their embedded value information.

67. Furthermore, the intrinsic value of the options and guarantees in embedded value approaches may not be calculated separately. Instead that value would be considered implicitly in the liability that is determined using best-estimate deterministic method[7] (termed 'deterministic best estimate liability (BEL)'). The entity then does another calculation of the liability using a stochastic method (termed 'stochastic BEL'). The difference between the liability calculated using the deterministic and stochastic method is the time value of the options and

[6] Sometimes called 'time value of financial option and guarantees (TVFOG)', 'future options and guarantees (FIG), cost of future options and guarantees (CFOG), or similar name.

[7] A deterministic model considers only one outcome. Stochastic models consider a range outcomes using either a mathematical formula or simulation techniques

guarantees. Those options and guarantees refer to those that pay out on an insured event and non-insured event.

68. Therefore, for practicality reasons, the staff has assumed that the IASB would not divide the change in value of options and guarantees into an element relating to cash flows and an element relating to the effect of discount rate changes, as would be the case if the general model were applied to such changes in estimates. As discussed in paragraph 59(b), some think that there should be no separate requirements for options and guarantees. But instead that the options and guarantees should be accounted for consistently with other features.

Should options and guarantee be recognised in the margin or in SCI?

69. Some think that the starting point of the analysis should be to see if options and guarantees could be presented consistently with the decisions for contracts that do not have participating features. However, changes in the value of these options and guarantees are a mixture of both changes in the estimates of cash flows and the effects of changes in the discount rate. Consequently, assuming that the IASB does not require entities to separate the cash flow and discount rate components for the reasons discussed in paragraphs 62-68, a valid case can be made for either recognising those options and guarantees in the margin or in SCI, depending on how the changes in the value of these options and guarantees are viewed.

Margin

70. Some argue that the value of these options and guarantees is considered in determining the margin on Day 1 and, therefore, that the changes in value of options and guarantees on Day 2 should adjust the contractual service margin. Proponents of that view believe that adjusting the contractual service margin for changes in the value of options and guarantees results in a better representation of the total unearned profit of the contract.

71. However, some support recognising changes in the value of options and guarantees as adjustments to the margin only because they do not support recognising those changes in OCI. They are concerned that the effects of options and guarantees may never be recognised in profit or loss.

72. Some that support recognising changes in the value of options and guarantees as adjustments to the margin would also support recognising changes in the value of the options and guarantees in profit or loss when the margin is exhausted. This is consistent with the IASB's decisions for contracts with no participating features. The staff note that the other alternatives discussed in paragraphs 31-44 on the measurement of the margin will either be affected when the margin is positive or rebuilt differently to a contract with no participating feature.

73. However, some that support options and guarantees as an adjustment to the margin would recommend another adaptation. They would recognise changes in estimates after the margin is exhausted in OCI instead of profit or loss.

74. One disadvantage of adjusting the contractual service margin for changes in the value of options and guarantees arises for entities that may choose to purchase derivatives as an economic hedge against their risk exposure from these options and guarantees. When that is the case, an accounting mismatch would arise in both the balance sheet and profit or loss when the changes in the options and guarantees are recognised against the margin because the value changes of these hedging derivatives are recognised in profit or loss. These economic hedges do not qualify for hedge accounting treatment under IFRS 9 and are not in the scope of the IASB's project on dynamic risk management.

75. The staff notes that hedging strategies differ. Some may hedge the risk exposure at the product type/portfolio level, others may hedge at an entity level. Most, if not all, entities do not fully hedge.

SCI

76. Some think that changes in the value of options and guarantees are similar to the effects of the changes in the discount rates that are recognised in the statement of comprehensive income or profit or loss. They believe that those options and guarantees do not relate to services and, therefore, that changes in the value of options and guarantees should not adjust the margin. They believe that the presentation of these changes in value should be consistent with the IASB's tentative decisions for contracts with no participating features— that the entity has an accounting policy choice to present effects of changes in discount rate in either

OCI, or profit or loss. (This assumes that the IASB will confirm that effects of discount rates can be recognised in OCI and extend the accounting policy option to contracts with participating features. This is discussed further in paragraphs 79-84). They believe that a consistent approach would be less confusing to users.

77. In addition, some note that recognising such changes in profit or loss or OCI (rather than as an adjustment to the margin) would:

(a) provide better information because, at the reporting date, changes in the value of options and guarantees would be reflected in the total liability recognised and the net equity amounts on the balance sheet. When those changes in value are instead recognised in the margin, there is no impact in the financial statements unless the margin is no longer positive.

(b) avoid the issue of accounting mismatch when derivatives are used as an economic hedge against the exposure to embedded options and guarantees, while still enabling entities that did not hedge with derivatives to exclude such value changes from profit and loss (see paragraphs 74-74).

Question 5—Options and guarantees
Do you have any comments on or questions whether there should be specific requirements on options and guarantees? If so, do you have any comments on how an entity should account for changes in the value of options and guarantees?

Presentation

78. This section discusses:

    (a) the presentation of interest expense (paragraphs 79-97); and

    (b) insurance contracts revenue (paragraph 98).

Presentation of interest expense

79. For contracts with no participating features, the IASB concluded at its meeting in March 2014 that:

    (a) when measurement inconsistencies do not result in a lack of faithful representation, it could be appropriate to measure financial assets at FVOCI or amortised cost and present the effect of changes in discount rates on the measurement of insurance contracts in OCI; and

    (b) it should allow entities to avoid accounting mismatches when they would result in financial statements that do not faithfully represent the reporting entity's financial position and performance by requiring that entities make an accounting policy choice whether to present the effect of changes in discount rates in either profit and loss or other comprehensive income.

80. In considering whether to extend these tentative decisions to contracts with participating features, the questions that arise are:

    (a) whether there are circumstances in which it would be appropriate to measure financial assets at FVOCI or amortised cost and present the effect of changes in discount rates on the measurement of insurance contracts in OCI for contracts with participating features; and

    (b) whether and how the IASB should allow entities to avoid any accounting mismatches that arise, if those accounting mismatches would result in financial statements that do not faithfully represent the reporting entity's financial position and performance.

81. In the feedback on the 2013 ED, some think that the proposals to present the effects of changes in discount rates in OCI:

    (a) is not suitable for contracts with participating features because of the variability of the cash flows caused by changes in the financial markets.

    (b) is not necessary if the IASB proceeds with the proposal to adjust the margin with the entity's share of underlying items. They think that this proposal resolves the same concerns that the recognition of effects of changes in discount rates in OCI addresses.

82. However, others think that it is important that entities should also be permitted to present in OCI the effects of changes in discount rates. Some would also include in OCI the changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items in OCI (discussed in paragraphs 55-57).

83. If the IASB decides that the effect of changes in discount rates for participating contracts should be presented in OCI, then feedback on the 2013 ED proposals indicates that an accounting policy choice should also be extended to contracts with participating features to address accounting mismatches. Some noted that the 'mirroring exception' dealt with accounting mismatches for only a narrow subset of participating contracts.

84. Some suggest alternative ways of determining the interest expense presented in profit or loss that could be used to avoid the accounting mismatches that arise because of the use of OCI. These suggestions are discussed in paragraphs 90-93.

Method for determining the interest expense

2013 ED proposal

85. The 2013 ED proposed that the interest expense is calculated using a discount rate that is:

    (a) locked-in at inception for cash flows that do not vary for underlying items; and

    (b) reset every time there are changes in estimates of investment returns that result in changes in the amounts paid to policyholders. Those

changes in estimates of investment returns are generally caused by changes in market variables which is also reflected in the current discount rates.

86. The cash flows for non-participating contracts are *not generally affected* by movements in interest rates. In contrast, contracts with participating features contain cash flows that are affected by investment returns, and thus *are affected* by movements in market interest rates. Movements in market interest rates also affect the discount rate used to measure the insurance contract. Consider the following example:

Example 3 interest expense

Assume a participating contract credits 100% of the cash flows resulting from an underlying pool of assets to the policyholder. The crediting rate is not contractually based but rather as a result of entity discretion. At the inception of the five year contract premiums of CU100 are received, and the discount rate and asset yield are 5%. For simplicity, there is no risk adjustment or margin associated with this component of the insurance contracts liability. At the end of the first year, the assets mature and the proceeds of CU105 are reinvested at a 10% asset yield (based on a shift in the risk-free rate). There are no further changes in the discount rate. (Errors may occur due to rounding.)

The undiscounted estimated cash flows (ie nominal), the present value of these cash flows based on a rate locked in at contract recognition, and the liability (based on the current rate) initially and at the end of years 1 and 2 is as follows:

					PV at	PV at	PV
			undiscounted		locked-in rate	current rate	differences
			(A)		(B)	(C)	(B)-(C)
initial liability			128		100	100	-
liability at the end of year 1			154	*	126	105	21
liability at the end of year 2			154		133	116	17
* 105 X 1.1 ^ 4							

The statements of comprehensive income and financial position based on the tentative decisions are as follows:

underwriting income	(21)	-
investment income	5	11
interest expense	(5)	(6)
net investment income	-	4
net income	(21)	4
OCI **	21	(4)
comprehensive income	-	-
	12/31/X1	12/31/X2
investment	105	116
insurance contracts liability	(105)	(116)
accumulated deficit	(21)	(17)
AOCI	21	17
** the OCI amounts in years' 1 and 2 represent the impact from the change in the discount rate (CU 21 in year 1) and the beginning of the subsequent reversal as the discount unwinds to interest expense ((CU 4) in year 2, calculated as the change in AOCI of CU 17 - CU 21)		

87. Example 3 illustrates why presenting the interest expense in profit or loss at the discount rate that is locked-in at inception may be less useful when the cash flow amounts (vs. solely time value) are affected by changes in the performance of assets, including interest rates. Specifically, using the locked-in rate, the amounts that would be recognized as interest expense arising from the unwinding of the discount rate on the insurance contracts liability would be inconsistent with the variable rate nature of the financing. The amounts credited to the policyholder account balance are akin to the interest payments on the amounts "borrowed" by the entity. Because these payments vary with changes in interest rates (ie to the extent of their effect on the amounts credited to the policyholder, which are often highly correlated), portraying the interest expense as if it resulted from fixed-rate financing would seem to be inconsistent with the overall objective of presenting changes in the insurance liability in a way that provides useful information to users. It would also be inconsistent with the accounting for floating rate debt instruments not marked to market through profit and loss (for example, at FVOCI), for which the "locked in" discount rate used to present interest expense is reset upon changes in interest rates.

88. Many agree that the discount rate for determining the interest expense for insurance contracts should be reset if the entity applies an accounting policy choice to recognise amounts in OCI. However:

    (a) many would reset the discount rate for **all** the cash flows for contracts with participating features, rather than for only cash flows that vary directly with returns on underlying items. Paragraph 10 discusses that these contracts contain a mixture of types of cash flows that vary and do not vary directly with underlying items, and in different proportions which may change over time.

    (b) Some think it would be more appropriate to use another discount rate to present the interest expense:

        (i) the portfolio book yield ('book yield') (discussed in paragraphs 90-93); and

        (ii) a discount rate calculated using an effective rate/level yield method (discussed in paragraphs 94-97).

89. The discount rate used for determining interest expense relates only to the presentation of interest expense in profit or loss and therefore, the amounts that would be recognised in OCI. The discount rate does not affect the measurement of the liability on the balance sheet.

Book yield

90. The book yield approach is consistent with how the underlying items are reported in profit or loss (ie market yield for assets held at FVPL and an amortised cost-based yield for assets held at amortised cost or FVOCI). When there are cash flows that extend beyond the current duration of the assets held, some would use an expected rate of return for those cash flows in the determination of the book yield.

91. The following is a description on how the proposed book yield would be calculated. The discount rate will need to be reset/re-determined when the underlying items are sold or matures and reinvested or if new underlying items are added.

Asset accounted for IFRS	Book yield
Debt instruments at amortised cost or FVOCI	Before the bond matures or is sold: the effective interest rate. Some would deduct "life time expected credit loss" (NB: which is different from the IFRS 9 impairment approach) and other adjustments made for the top-down or bottom-up approaches for determining the discount rate. After the bond matures: current market yield reflecting the rates at which the asset may be reinvested at.
Equities at FVOCI	An illiquid risk-free rate; or an expected dividend income stream.
Investment properties at cost	Expected rent adjusted for expected defaults.
Debt instruments at fair value	The current market yield. Some would apply further adjustments consistent with those made under the top-down or bottom-up approaches for determining the discount rate (for example, expected defaults).
Equities and investment properties at FVPL	Expected future total return. Some would apply further adjustments consistent with those made under the top-down or bottom-up approaches for determining the discount rate.

92. Those that support this approach think that it would report interest expense in profit or loss that is consistent with the interest income from the underlying items, and reduces or eliminates the accounting mismatch between the underlying items and the insurance contract in profit or loss. Consequently, they believe that this provides useful information.

93. Arguments against this approach are that:

    (a) some note that the underlying items may not be directly linked to the investment returns that are passed to the policyholder (for example, when there is discretion in the amounts and timings). In this instance, they question whether the proposal to present interest expense based on those investment returns would be a faithful representation of the interest expense.

(b) the book yield differs from the discount rate that is applied to the cash flows of the insurance contract. Some think that recognising interest expense in profit or loss that is measured using a discount rate that has no relationship to the rate that is used to measure the insurance contract does not provide useful information because the amount of interest expense that is recognised on a cumulative basis might not equal the effect of discounting on the liability. This is because the amount of interest expense is a function of the accounting basis for the underlying items. Accordingly, some think that the amounts in OCI would be difficult to explain except by reference to the mechanics.

(c) this approach would require the entity to identify the underlying items and therefore, the significant issues discussed in paragraphs 38-41 would need to be addressed.

Using a method similar to effective interest method

94. Another approach would be to use a discount rate that is determined using the effective interest method under IFRS 9. The entity would need to determine the discount rate using the method that exactly unwinds the amount in equity related to the effects of changes in the discount rate (some term this the accumulated OCI) over the life of the contract.

95. This approach was proposed in the FASB's Proposed Accounting Standards Update *Insurance Contracts* (Topic 834). (The FASB also proposed that an entity should recognise in OCI changes in the cash flows that arise from changes in estimates of investment returns.) Some that responded to the FASB's proposed Update supported the FASB's approach provided that it would be amended so that the discount rate would reflect the crediting pattern. Some that responded to the 2013 ED recommended that the IASB consider a similar approach.

96. Those that support this view note that this is consistent with the amortised cost and (FVOCI) requirements in IFRS 9. Consequently, they believe it provides information that is readably understandable because amortised cost is a well understood measurement basis. This approach would require the entity to identify

the underlying items and therefore, the issues discussed in paragraph 38-41 would need to be addressed.

97. However some note that this proposal would require entities to do an additional calculation to determine the interest expense at every reset date, and that this would introduce complexity.

Question 5—Presentation of interest expense
Do you have any comments or questions on the staff's analysis of the presentation of interest expense for contracts with participating features?

Insurance contracts revenue

98. The staff believe that there are no adaptations needed for the proposals on insurance contracts revenue for contracts with participating features if the 2013 ED proposals for contracts with participating features are unchanged. However, if the margin was adjusted for the entity's share of underlying items as proposed by some (discussed in paragraphs 31-44), further adaptations to the proposals for insurance contract proposals may be needed. One of the factors of the IASB's previous discussions is that the insurance revenue is the allocation of the premiums over the coverage period for the insurance coverage provided. If the changes in entity's share of the underlying items were adjusted in the margin as proposed by some, the insurance contract revenue would no longer represent an allocation of the premiums for the insurance coverage provided.

Question 6–Other questions
Do you have any comments or questions on any other aspect of the accounting for contracts with participating features?