STAFF PAPER

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Project	Insurance Contracts		
Paper topic	Adaptations for insurance contracts that provide policyholders with investment returns: Background and scope		
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Purpose of this paper

1. This paper:
   (a) provides a reminder of the IASB's tentative decisions for contracts with **no** participation features (paragraphs 4-15);
   (b) considers whether (paragraphs 15-29), and in what circumstances (paragraphs 30-41), adaptations are needed to those decisions for insurance contracts that provide policyholders with payments that vary with the returns on underlying items (referred to as "participating contracts").

2. This paper also describes other arguments for making adaptations for contracts with participation features that IASB has considered and explains why the staff does not find them persuasive (paragraphs 44-55).

3. The staff is not asking for decisions at this meeting.

General model for contracts with no participation features

4. The IASB is considering the accounting for contracts with participation features in the context of adaptations that might be needed to the general model for contracts with no participation features. Accordingly, the staff begins with a summary of the IASB's approach for non-participating contracts for measurement (see

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paragraphs 4-9), and presentation and disclosure (see paragraphs 10-15). This summary reflects the proposals in the IASB's 2013 Exposure Draft *Insurance Contracts* (the 2013 ED), modified by the IASB's tentative decisions during the redeliberations on the 2013 ED. The measurement approach is illustrated in paragraph 12.

Measurement

5. The IASB's approach measures insurance contracts using a current value approach which incorporates, at initial recognition:

   (a) A current, unbiased estimate of the cash flows expected to fulfil the insurance contract. The estimate of cash flows reflects the perspective of the entity, provided that the estimates of any relevant market variables do not contradict the observable market prices for those variables. It includes all the cash inflows and cash outflows that relate directly to the fulfilment of the insurance contract[1]. Investment returns on assets held by the insurer are excluded from the estimate of cash flows, and those investments are recognised, measured and presented separately.[2]

   (b) An adjustment for the time value of money, using discount rates that reflect the characteristics of the cash flows. The discount rates are consistent with observable current market prices for instruments with cash flow characteristics that are consistent with those of the insurance contract. Thus the discount rates exclude the effect of any factors that influence the observable market prices but that are not relevant to the cash flows of the insurance contract. Accordingly, to the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends wholly or partly on asset returns, the characteristics of the liability reflect that dependence.[3]

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[1] Paragraph 22 of the 2013 ED.

[2] Paragraph B67(a) of the 2013 ED. However, as noted in paragraph B67(a), the measurement of an insurance contract may be affected by the cash flows, if any, that depend on the investment returns.

[3] Paragraphs 25 and 26 of the 2013 ED.

(c) An adjustment for the effects of risk and uncertainty[4]. The risk adjustment is defined as being the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract. [5] The risk adjustment reflects all the risks associated with the insurance contract, other than those reflected through the use of market consistent inputs. It does not reflect the risks that do not arise from the insurance contract, such as investment risk relating to assets that an entity holds, (except when the investment risk affects the amounts payable to policyholders), asset-liability mismatch risk or general operational risk that relates to future transactions.[6]

(d) An amount (referred to as the contractual service margin) that reflects the excess of the consideration charged for the contract over the risk-adjusted expected present value of the cash outflows expected to arise as the entity fulfils the contract. The contractual service margin is a measure of the service the entity would perform in fulfilling the contract. Accordingly the entity would not recognise the excess as an immediate gain, but would instead recognise that gain over time as the entity satisfies its obligation to provide service over the coverage period. If the consideration charged for the contract is less than the risk-adjusted expected present value of the cash flows the entity expects to arise as it fulfils the contract, the entity recognises an immediate loss in profit or loss.

6. Thus the IASB's approach represents an insurance contract as comprising both:

(a) An obligation to pay net future cash outflows, represented in 3(a) to 3(c), and referred to collectively as the fulfilment cash flows[7]; and

[4] Paragraph 27 of the 2013 ED.

[5] Appendix A of the 2013 ED

[6] Paragraphs B78 of the 2013 ED.

[7] The 2013 ED defined the fulfilment cash flows 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."

(b) An obligation to provide insurance coverage over the coverage period, represented by the contractual service margin.

Together, the fulfilment cash flows and the contractual service margin provide an updated representation of the entity's obligations arising from the insurance contract.

7. The objective of this approach is to achieve a valuation of the insurance contract, including any options and guarantees embedded in that contract, in a manner that is consistent with market information. However, the measurement of insurance contracts is a current expected value measurement rather than a fair value measurement. This reflects the IASB's conclusion that fair value would not be an appropriate measurement attribute for insurance contracts because insurance contracts are usually settled by satisfaction of the obligation, rather than traded. Consequently, the IASB's valuation approach takes into account the fact that an entity expects to fulfil the contracts, rather than transfer them. In other words, the approach reflects the IASB's view that an insurance contract combines the features of both a financial instrument and a service contract.

8. Because the service component and the financial instrument component of the contract are interrelated, the model does not propose that the components should be unbundled and accounted for separately. However, the IASB's aim is to achieve consistency where possible between the reporting for the features of each component under this proposed Standard and the reporting for that component had it been reported separately. In particular, and consistently with other IFRSs, the IASB believes that the changes in estimates relating to the service component provides different information value from changes in estimates relating to the financial instrument component. As a result, the model treats changes in different types of estimates after inception differently, as follows:

   (a) The entity accounts for changes in estimates relating to the service component in a way similar to the outcome that would be achieved if the entity had applied the revenue recognition model to that component. As a result:

      (i) Favourable and unfavourable differences between current and previous estimates of the fulfilment cash flows arising

from changes in estimates of cash flows and risk adjustment that relate to future coverage, are absorbed in the contractual service margin (sometimes referred to as unlocking the contractual service margin), subject to the condition that the contractual service margin is not negative. The effect of such changes are recognised in profit or loss only when the related service is provided.

(ii) The contractual service margin is recognised in profit or loss as the entity provides service under the insurance contract. The IASB has concluded that the service in a non-participating contract is the provision of insurance coverage, which is provided on the basis of the passage of time. The contractual service margin should also be recognised at a level of aggregation such that, once the coverage period of the insurance contract has ended, the related contractual service margin has been fully recognised in profit or loss. Therefore the aggregate amount of contractual service margin recognised in the period reflects the number of contracts in force.

(iii) Changes in estimates related to current or past periods' service, or that do not relate to service would also be recognised in profit or loss.

(b) The entity accounts for changes in estimates relating to the financial component in a way similar to the effect that would be achieved if the entity had applied the financial instruments model to that component. As a result, changes in estimates relating to the financial components, including the effects of changes in discount rates, are recognised in profit or loss or other comprehensive income in the period in which the change occurs. Recognising changes in discount rates in the statement of comprehensive income (rather than as an adjustment to the contractual service margin) also reduces accounting mismatches between insurance contracts and the assets that an entity holds, as the effect of changes in discount rates for both items would be recognised in the statement of comprehensive income.

9. Because the assets the entity holds are not part of the insurance contract, the gains and losses on those assets are accounted for in accordance with other applicable IFRSs. The difference between changes in value of assets and liabilities portrays the entity's net exposure that arises from the change in economic circumstances.

Presentation and disclosure

10. The IASB also proposes a presentation approach for the statement of comprehensive income that would:
    (a) align the presentation of revenue and expense with that required for other contracts with customers. This would make the financial statements of entities that issue insurance contracts easier to understand for generalist users of those financial statements.
    (b) provide information about the main sources of profits for entities that issue insurance contracts.
    (c) allow entities to recognise the effects of changes in discount rates on the measurement of insurance contracts in other comprehensive income. This would enable entities to reduce any accounting mismatch in profit or loss between interest expense on insurance contract liabilities and the related investment income from assets that report amortised cost information in profit or loss.

11. The information in the financial statements would be supplemented by comprehensive disclosures that would require the entity to explain:
    (a) The judgements needed in arriving at the amounts recognised in the financial statements.
    (b) The changes in the components of the insurance contracts measurement, including a reconciliation of the amounts presented in the statement of comprehensive income; and
    (c) The nature and extent of risks arising from insurance contracts.

Example

12. The following simplified example summarises the accounting for a non-participating insurance contract at inception, as follows:

Assumptions

A policyholder pays a premium of CU1,000 for a 5-year non-participating insurance contract. In exchange the entity promises to pay the policyholder claims if an insured event occurs. The entity expects that it will need to pay a claim of CU1,249 at the end of Year 5. The liability discount rate is 5%. For simplicity the risk adjustment is zero and there are no other expenses. Thus the present value of expected claims is CU1,249/1.05^5= CU979.

Initial recognition

The fulfilment cash flows at initial recognition (immediately before the premium is received) are CU1,000 - CU979= CU21, and this means the contractual service margin at inception is CU21 to eliminate the gain at inception. When the entity receives the premium of CU1,000 at initial recognition, the fulfilment cash flows are CU(979).

The entity recognises the following journals at inception:

Dr Cash (Premiums received)	1,000	
Cr insurance contract (fulfilment cash flows (FCF))		979
Cr insurance contract (CSM)		21

Thus, the entity expects to make a profit of CU21 over the coverage period of the contract. In addition, the entity immediately invests the premium of CU1,000 received, and records the following journal entries:

Dr investment	1,000	
Cr cash		1,000

Subsequently

After initial recognition, the entity recognises the unwind of the discount on the insurance contract liability as an interest expense (ie CU1,249 discounted at 5% for 5 years – CU1,249 discounted at 5% for 4 years = CU48). If there are no changes in the expected claim, and no changes in the discount rate, then there are

no other changes to the insurance contract.

Dr P&L interest expense 48

Cr insurance contract (fulfilment cash flows) 48

Changes in the value of the investment are recognised in accordance with other applicable IFRS. Assuming the investment is an equity instrument accounted for at fair value through profit or loss applying IFRS 9, and the fair value of the equity instrument changed to CU1,200 (ie an increase in value of CU200), the entity would record the following journals:

Dr investment 200

Cr P&L investment income 200

13. Under the IASB's proposals for non-participating contracts, the sources of profit for insurance activities are recognised and presented in profit or loss for each period as follows:

(a) The underwriting result arises from both the remeasurement of the risk adjustment and the allocation of the contractual service margin in profit or loss. In the example above, the risk adjustment is zero and so the profit for the period arises only from the allocation of the contractual service margin. The allocation of the contractual service margin is on the basis of the passage of time, ie CU4 each period.

(b) The investing result arises as the difference between (a) the gains and losses from the investment and (b) the interest expense on the insurance contract liability. In Year 1, this is (a) CU200 minus (b) CU48.

14. As noted in paragraph 4, the IASB is considering the accounting for contracts with participation features in the context of adaptations that might be needed to the general model for contracts with no participation features. The next section considers what those adaptations might be.

Adaptations for contracts that provide policyholders with payments that vary with the returns on underlying items

15. In participating contracts, the transaction can be characterised as follows:

(a) The policyholder pays a premium to the entity.

(b) The entity pays claims on the occurrence of the insured event.

(c) The entity invests the premium for the policyholder. The policyholder expects to receive a return on the premiums paid, referenced to an underlying investment pool that is referred to as the underlying items[8].

(d) The entity returns to the policyholder the premium plus the returns on the underlying items. (If the returns on underlying items are negative, then the entity would reduce the premium returned to the policyholder by the negative returns). In addition, the entity may provide a minimum return, such as a guaranteed return of the premiums paid.

(e) The entity charges a fee for the service provided by the contract. This compensation to the insurer is usually expressed as a portion of the underlying items, or as a portion of the return on the underlying items. The entity deducts this fee from the amounts it pays to the policyholder under (d).

(f) In many cases, the policyholder has the option to cancel the contract and receive the premiums paid plus returns on the underlying items less fees and other applicable charges. The entity does not have the equivalent option to cancel the contract.

The features of these contracts set out in (a) and (b) above are consistent with those of non-participating contracts, and can be considered the non-participating features. The features set out in (c) to (f) generally arise only in contracts with cash flows that vary with underlying items, and are referred to as participation features. This section considers whether adaptations are needed for such participation features.

16. Some believe that the presence of participation features in the contract results in a need for adaptations to the IASB's general model for insurance contracts to ensure

[8] For simplicity, this paper assumes that the underlying items are financial assets held by the insurance entity, and accounted for within the scope of IFRS 9. However the underlying items may be a referenced pool of assets not held by the entity, and/or could include other types of assets, groups of specified assets and liabilities, or a pool of assets and liabilities including those that reflect other factors such as mortality gains and losses.

that there is a faithful representation of the entity's interest in the underlying items. Accordingly, the entity's interest in the underlying items can be viewed:

(a) as a share of economic returns from the underlying items, which is the outcome if the IASB's approach to non-participating contracts were to be applied to the contract with participation features (paragraphs 17-22); or

(b) as a variable fee for service (paragraphs 23-29).

The paragraphs below consider those two views.

Viewing the entity's interest in the underlying items as a share of economic returns from the underlying items

17. If the IASB's approach to non-participating contracts were applied to the participation features of insurance contracts, the investing activity would be reported as the difference between (a) the gains and losses on the entity's investment portfolio, which would be recognised in profit or loss according to other applicable IFRS and (b) the interest expense on the insurance contract liability. In other words, the entity's investment portfolio would be accounted for in the same way as a standalone investment that the entity owns and controls. Under this approach the entity's profit arises from the difference between the returns from the investments, and the payments that the entity makes to the policyholder out of those returns.

18. The staff notes that in most cases, the entity has legal title for the investment portfolio, and retains the obligation to pay the policyholders the amounts that are determined on the basis of the underlying items irrespective of the entity's investment strategy. Furthermore, an entity is unlikely to have a legally enforceable right to set off the insurance contract liability with the investment portfolio, even if the investment portfolio is invested in assets which exactly match the underlying items. Accordingly, some argue that it is appropriate to view the investment portfolio as controlled and owned by the entity, irrespective of whether it exactly matches the underlying items.

19. Supporters of this view question whether an approach that depicts the entity as receiving only a variable fee for service (as described in paragraphs 23-26) would

provide a faithful representation of the economics of the contractual arrangement. They observe that even when an entity is required to pass to policyholders a substantial proportion of the variable returns from an investment portfolio that the entity controls, the entity controls the cash flows and its primary aim is to increase its own share of those cash flows, even when the entity is required to act in a fiduciary capacity for the policyholder. In their view, the policyholder is entitled only to a portion of the returns, and the remaining returns are due to the entity.

20. Therefore, those that view the investment portfolio as controlled and owned by the entity believe that depicting the gains and losses on the entity's share of the underlying items in the same way as a standalone investment would be appropriate, because it would reflect the entity's control of the investment portfolio. Thus, only the net gains and losses that the entity passes to the policyholder through the participation mechanism would be recognised as changes in the insurance contract liability, and only that net amount would have an offsetting effect against the gains and losses recognised on the entity's investment portfolio.

21. Under this proposal, the financial statements of the entity will reflect a net investment return even if the returns on the assets the entity actually holds exactly match the returns on the promised underlying items. That net investment return would portray the net effect of entity's exposure to changes in economic variables, as for non-participating contracts.

22. Accordingly, those with this view believe that reporting the entity's interest in underlying items on a consistent basis with other investments controlled by the entity would result in more transparent and understandable reporting in primary financial statements of the changes in circumstances affecting both the underlying items and the entity's obligations to policyholders.

Viewing the entity's interest in underlying items as a variable fee for service

23. In contrast, some note that any benefit the entity receives from its share of invested underlying items is only as a consequence of holding those items on behalf of the policyholder, and so believe that it is inappropriate for the entity to report the gains and losses on its share of those underlying items as if it partly

owned the items. In particular, some observe that the entity is often constrained because:

(a) the quantum of underlying items is determined entirely from the premiums paid by the policyholder,

(b) the entity is usually expected to manage the policyholder's invested premiums for the benefit of the policyholder,

(c) the entity must generally follow the investment strategy specified in the contract, and

(d) the entity is usually required to act in a fiduciary capacity for the policyholder.

Thus, some believe the policyholder receives all the variable returns from the underlying items and that the policyholder pays the entity a variable fee out of the proceeds of its investment. That the variable fee is determined by reference to a share of the returns on the underlying items is incidental to its nature as a fee.

24. Accordingly, supporters of this view believe that the entity's interest in a portion of the underlying items in a participating contract should not be viewed as a net investment return or an investment spread between investments in the entity's own assets and the amount paid to policyholders. Instead, they believe that the accounting outcome should reflect the fact that the policyholder is entitled to all the variable returns from the underlying items. Under this proposal, the financial statements of the entity would report a net investment return only to the extent that return on the assets the entity holds do not match the returns on the promised underlying items.

25. That outcome would be achieved if the entity's obligation to the policyholder were to be considered to be the net of (a) the obligation to pay the policyholder an amount equal to the value of the underlying items and (b) the fee that the entity expects the policyholder to pay in exchange for the services provided by the insurance contract. That fee is determined at an amount that incorporates the entity's share of returns from underlying items less the other costs of providing the contracts, in particular the costs of providing guarantees. The policyholder pays the fee by foregoing part of the proceeds on the underlying items.

26. Thus, for the insurance contracts described in paragraph 15:

    (a) The policyholder deposits a premium with the entity.

    (b) The entity pays claims on occurrence of the insured event.

    (c) The entity invests the premium for the policyholder's benefit in investments that are referred to as the underlying items[9].

    (d) The entity pays to the policyholder an amount equal to the value of the underlying items less the fee the entity charges for providing services. The fee charged is intended to cover any insured claims or guaranteed amounts.

    (e) In many cases, the policyholder has the option to cancel the contract and receive the underlying items plus returns to date less applicable charges. The entity does not have the equivalent option to cancel the contract.

27. Accordingly, those with this view believe that reporting the entity's interest in underlying items as if it is a variable fee for service would result in more transparent and understandable reporting in primary financial statements of the nature of the contractual arrangement.

28. Paragraphs 30-41 consider when the entity's obligation to the policyholder could be viewed as the obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee, if the IASB were to choose that approach. Viewing the entity's interest in underlying items as a variable fee has the following consequences, which are discussed in Agenda Paper 2B *Adaptations for insurance contracts that provide policyholders with investment returns: Proposed accounting for CSM and OCI*:

    (a) Changes in the estimate of the obligation to pay to the policyholder an amount equal to the value of the underlying items should be accounted for in a way that reflects changes in the value of the underlying items.

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[9] For simplicity, this paper assumes that the underlying items are financial assets within the scope of IFRS 9. However the underlying items could include other types of assets, groups of specified assets and liabilities, or a pool of assets and liabilities including those that reflect other factors such as mortality gains and losses.

(b) Changes in the estimate of the variable fee for future services should be accounted for in a way consistent with the changes in estimate relating to future service. Accordingly, such changes in estimates would be adjusted in the contractual service margin so that they would be recognised in future periods, rather than in the period in which they occur.

29. At inception, the variable fee for future services comprises the entity's share of the returns on underlying items less the expected outflows that relate to any non-investment cash flows or to pay for guarantees. As a consequence, this approach would mean that changes in the value of any options or guarantees in the contract would be adjusted against the contractual service margin.

Question 1: Entity's share of economic returns vs variable fee for service
Do you have any comments or questions regarding whether the nature of the entity's interest in the underlying items should be viewed as (a) a share of economic returns from the underlying items; or (b) a variable fee for service.

When the obligation is to pay the policyholder an amount equal to the value of the underlying items less a variable fee

Need to specify a scope

30. The staff believe that the optimal outcome for the new insurance contracts Standard would be consistent accounting for insurance contracts with participation features and insurance contracts that do not have participation features. This would satisfy the IASB's objective of developing a single model suitable for all types of insurance contracts and avoid the need to draw an arbitrary dividing line between contracts with and without substantial participation features.

31. However, if the IASB were to accept the argument that, in some circumstances, the entity's obligation to policyholders is to pay to the policyholder the value of the underlying items less a variable fee for service, then the question arises as to

when those circumstances occur. This is because such an approach would have a different accounting outcome compared to the general approach even though the investment returns on the underlying items acquired with premiums is a source of profits for entities, when both participating and non-participating insurance contracts are issued.

32. The different accounting outcomes arise because, when the entity is viewed as earning a variable fee for service, it would offset in the contractual service margin the effect of its own exposure to variable underlying items. This would not be the case in the general approach, in which the contractual service margin is not adjusted for the effect of changes in the entity's exposure to assets the entity holds. Consequently, viewing the entity's interest in underlying items as a fee for service will create a difference in the way that insurance contracts are accounted for.

33. Accordingly, regarding the obligation as the obligation to pay an amount equal to the value of the underlying items less a variable fee for service would make it necessary for the IASB to specify the contracts for which that view is valid. In other words, the IASB would need to specify the scope of this approach. That scope would distinguish when an entity earns a variable fee for service, rather than an investment return or spread.

Proposed criteria

34. In June 2014, the IASB indicated that, if it were to require an entity to adjust the contractual service margin for changes in the entity's share of underlying items on the grounds that the entity's share represents an implicit management fee, then the staff should consider that question under the assumption that an implicit asset management fee should be considered to exist only when:

    (a) The returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders);

    (b) There is a minimum amount that the entity must retain; and

(c) The policyholder will receive a substantial share of the total return on underlying items.

35. The IASB asked the staff to continue work on this basis. However the staff thinks that the criteria in paragraph 34 should be revisited, to be consistent with the view that the entity's obligation is to pay the policyholder an amount equal to the value of underlying items less a variable fee for services. In the staff's view, this view would be valid only when:

(a) The contract specifies that the policyholder participates in a clearly identified pool of underlying items. This is because a clearly identifiable pool of underlying items is necessary to determine the value of the underlying items. This criteria is discussed further in paragraphs 36 -39.

(b) the entity expects that a substantial proportion of cash flows from the contract will vary with changes in underlying items. The obligation to the policyholder cannot be regarded as being an amount equal to the value of underlying items if cash flows relating to the underlying items are **not** a substantial portion of the obligation to the policyholder

(c) The entity expects the policyholder to receive an amount representing a substantial share of the returns from underlying items (equivalent to the criterion in paragraph 34(c)). In other words, the fee charged by the entity should not be a substantial portion of the returns because the obligation to the policyholder cannot be regarded as being an amount equal to the value of underlying items if the policyholder is not exposed to a substantial portion of the variability in the value of the underlying items.

36. The staff observes that, as noted in previous discussions, qualitative criteria that rely on hurdles such as "substantial proportion" or "substantial share" rely on the entity's judgement and increase the risk of lack of comparability. However, the staff thinks that a degree of judgement in this area is inevitable.

37. Accordingly, the staff propose that the conditions in paragraph 35 should be used to define the scope of when an entity's interest in the underlying items could be viewed as a variable fee for service.

Clearly identifiable underlying items

38. Paragraph 35(a) proposes that clearly identifiable underlying items should be a condition for an approach that views the entity's obligation as being to pay to the policyholder an amount equal to the value of the underlying items less a variable fee. The IASB previously discussed the challenges that arise in identifying the underlying items. Those challenges arise because there is not always a clear contractual linkage between the returns to policyholders and ring-fenced underlying items, as would be the case, for example in a unit-linked contract with a legally segregated fund of assets. In the staff's view, there would not be clearly identifiable underlying items in the following cases:

    (a) When the entity can retroactively change the underlying items that determine the amount of the entity's obligation. The staff think that, if an entity is able to change the underlying items that determine its obligation, then an entity has, in effect, an obligation to pay a discretionary amount, rather than an amount that is based on specified items. Therefore the staff think that an entity's ability to retroactively change the underlying items means that the obligation to the policyholder is not based on clearly identified items.

    (b) When there are no underlying items identified, even if the policyholder could be provided with an interest-like return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. Such a return could be in the form of a crediting rate or dividend payment. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set.

39. 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 particular, the IASB noted that for some entities, the underlying items that the entity designates to portfolios may not be sufficient to meet its obligations in all circumstances.

Criteria previously discussed that are not necessary

40. The staff believes that two of the conditions that the IASB previously discussed (see paragraph 34) would not be necessary, as follows:

    (a) The returns to be passed to the policyholder need not arise from items the entity holds. In other words, the criteria in paragraph 34(a) is not necessary. This is because an entity's obligation to pay the policyholder an amount equal to the value of the underlying items (less a fee) is not altered if the entity chooses to take risks by investing the premiums in items that are different from the specified underlying items elsewhere. However, if the entity holds assets other than the underlying items, then the economic mismatch between the entity's assets and the obligation to the policyholder would be reported in the statement of comprehensive income.

    (b) There need not be a minimum amount that the entity must retain. In other words, the criterion in paragraph 34(b) is unnecessary. That criterion reflected the view that a fee should never be negative. However, at inception, a contract with a negative fee would be recognised as an onerous contract. Entities would otherwise expect a positive fee, and losses that arise because the fee is not as expected are, in principle, no different to other losses that arise that were not originally expected.

41. The appendix to Agenda Paper 2B illustrates how the scope the staff propose in paragraph 35would apply to contracts with different features.

Comparison to scope proposed by the European CFO Forum

42. The staff notes that, at the November education session, the European CFO Forum proposed a scope that would include "all contracts which provide policyholders with a right to receive, as a supplement to the guaranteed benefits, a variable return either contractually or at the discretion of the issuer. According to that proposal, the variable return could be based upon one or more of the following:

    (a) the performance of a specified pool of contracts or a specified type of contract;

(b) realised and/or unrealised investment returns on a specified pool of assets; or

(c) the profit or loss of the company, fund or other entity that issues the contract."

43. The staff's proposal is more restrictive than the CFO Forum's proposal in that the staff would restrict adaptations for participating contracts only to those contracts for which an entity's obligation can be viewed as the obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee. Thus, it would exclude, for example, contracts for which the obligation to the policyholder is not based on a clearly identified pool of underlying items, as discussed in paragraphs 36-39.

Question 2:When the obligation is to pay the policyholder an amount equal to the value of the underlying items less a variable fee
The staff propose that the entity's interest in underlying items could be considered to be equivalent to a variable fee for service only when the following criteria are met: (a) The contract specifies that the policyholder participates in a clearly identified pool of underlying items; (b) the entity expects that a substantial proportion of cash flows from the contract will vary with changes in underlying items; and (c) The entity expects the policyholder to receive an amount representing a substantial share of the returns from underlying items. Do you have any comments or questions about these criteria?

Other arguments considered

44. One of the consequences of regarding the entity's obligation as an obligation to pay the policyholder an amount equal to the underlying items less a variable service fee is that the contractual service margin would be adjusted for changes in the net fee for service, which comprises the entity's share of the returns on underlying items less the cost of guarantees and any fixed cash flows relating to future service. In previous education sessions, the IASB has heard other

arguments that were intended to justify an approach in which the contractual service margin for the insurance contract is adjusted to reflect changes in those items. Those arguments include the following:

(a) The separation of different sources of profit is artificial (paragraphs 46-48).

(b) The cash flows at inception include the cash flows relating to investment in underlying items and adjustment is needed for consistency with day-1 measurement (paragraphs 49-50).

(c) Adjusting the contractual service margin is needed to achieve an appropriate recognition pattern for changes in value of underlying items (paragraphs 51-52).

(d) Consistency with IFRS 15 *Revenue from Contracts with Customers* (paragraphs 53-55).

45. However, the staff were not persuaded by those arguments, for the reasons discussed below.

The separation of different sources of profit is artificial.

46. Some argue that reflecting all changes in expected profits from insurance contracts and underlying items in the contractual service margin would avoid an artificial separation of different sources of profit. In other words, profit sources from investing, underwriting and other services would be treated in the same way. Those with this view regard the transaction between the policyholder and the entity as an agreement for the entity to receive compensation from a combination of profit sources in exchange for the provision for services. Additionally, they believe that all the services for the contract are provided over the contract life.

47. However, the staff note that transparent reporting of different sources of profit is a key objective of the IASB's project on insurance contracts. In the past, users of financial statements told us that they believed it would be useful if financial statements identified the contribution to the net profit or loss arising from the underwriting performance separately from that arising from investing activity. Thus, in the 2013 ED, the IASB placed weight on the view that it would be useful to provide information about an entity's underwriting performance separately

from the entity's investing performance and proposed that an entity should achieve this by segregating the effect of changes in discount rates (ie the investing performance) from other changes in the insurance contract liability, and in further separating the investing performance into an amortised cost view, and a current value view of investing performance. That separation is also consistent with the principle of separately presenting the effect of financing in other IFRS: it is common to present interest expense as a separate line item.

48. The separate presentation of underwriting and investing performance would not be achieved if the contractual service margin were to be adjusted by changes in investing returns, which include the effects of changes in market interest rates, because the contractual service margin that would be released to profit or loss in each period would no longer comprise solely underwriting results. That would reduce transparency about the sources of profit and loss. Accordingly, such an approach would be appropriate only in the circumstances where the entity is viewed as not having any investing performance on its own account.

Cash flows relating to investment in underlying items

49. Some observe that the contractual service margin can be characterised as being determined by including the expected investment cash flows in the fulfilment cash flows. Proponents of this view believe that such investment cash flows form an intrinsic part of the contract with the policyholder, and that, for this reason, changes in the estimates of those expected investment cash flows should adjust the contractual service margin.

50. However, the staff note that the 2013 ED proposals excluded investment returns from the determination of the contractual service margin, because they relate to a separate transaction. The 2013 ED required the investments to be recognised, measured and presented separately, on a consistent basis with similar investments held by entities that do not issue insurance contracts. Accordingly, the contractual service margin would represent the obligation for providing services under the contract, measure at the amount of unearned profit for providing those services. It would not include the expected gains and losses on the investments held by the entity.

Recognition pattern for changes in value of underlying items

51. Some believe that it would provide more useful information about the long-term performance of the entity to recognise changes arising from expected returns on assets backing insurance contracts over future periods, rather than in the period those changes in expectations arise. This is because they believe that the value change in the underlying items should not be considered as earned in the period of the change, but should instead be considered to be earned over the coverage period.

52. The staff note that the IASB's objective is to ensure that profits are recognised in the period that they are earned. The question is when profits should be regarded as earned. Most agree that profits relating to insurance risk and underwriting are earned in the period when the entity provides the service of insurance coverage. However, the appropriate period for recognising profits relating to changes in the value of underlying items is specified by the Standard applicable to the underlying item. Thus, appropriate recognition of profit arising from underlying items should, arguably, provide the same information as if the entity had held a standalone investment equivalent to the share of underlying items. In contrast, recognising the change in value of the underlying items over the remaining contract terms would mean that profits and losses from underlying items would instead be recognised in future periods.

Consistency with IFRS 15

53. Some suggest that primary justification for adjusting the contractual service margin for changes in the entity's share of returns on underlying items is to ensure that the changes in the estimate of the consideration for the insurance contract should be reported in a consistent way with variable consideration in accordance with IFRS 15. IFRS 15 requires that the entity estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer, subject to the constraint that the entity includes in the transaction price some or all of an amount of variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

The transaction price so determined is recognised as the performance obligations in the contract are satisfied.

54. In particular, the following comparisons have been made:

(a) Some regard the payment of the premium as analogous to a payment for services in a contract within the scope of IFRS 15. In this case, the transaction price is the amount of the payment, and any investment made with the premium would be accounted for using applicable standards for the type of investment (eg financial instruments would be accounted for under IFRS 9, investment property would be accounted for under IAS 40 etc). In that case, the entity would recognise profit from the service contract separately from the gains and losses it makes on the investment. For example, if the entity invested the prepayment received for a cleaning service contract in an equity instrument, the transaction price of the cleaning service would be the cash received, which would be equal to the fair value of the equity instrument on the date the equity instrument is acquired. Any changes in the value of the equity instrument would be recognised in accordance with IFRS 9.

(b) Some argue that changes in the entity's share of underlying items could be regarded as variable consideration, based on the returns on underlying items. In essence, the insurer would be regarded as paying to the policyholder the net of 100% of the returns on the underlying items less the variable consideration. Under IFRS 15, the entity would update the estimated transaction price at the end of each reporting period, subject to constraining the estimate of the variable consideration.

55. However in the staff's view, there is limited benefit in seeking to extend completely the analogy to IFRS 15 because IFRS 15 was not developed to apply to contracts with highly variable cash flows, such as insurance contracts, and IFRS 15 deals with *revenue* recognition, which may have different considerations to *profit* recognition. In particular, IFRS 15 becomes problematic when applied to contracts with high variability of outflow (such as insurance contracts), because the measurement of the performance obligation is entirely an allocation (subject to an onerous test).