IAN 7

Recognition and Measurement of Contracts with Discretionary Participation Features under International Financial Reporting Standards IFRS [2005]

Prepared by the
Subcommittee on Education and Practice of the
Committee on Insurance Accounting

Published 16 June 2005
Reformatted to IAN 7 on 24 January 2012
Updated on 28 March 2014

This International Actuarial Note (IAN) is promulgated under the authority of the International Actuarial Association. It is an educational document on an actuarial subject that has been adopted by the IAA in order to advance the understanding of the subject by readers of the IAN, including actuaries and others, who use or rely upon the work of actuaries. It is not an International Standard of Actuarial Practice ("ISAP") and is not intended to convey in any manner that it is authoritative guidance.

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1. Scope

The purpose of this INTERNATIONAL ACTUARIAL NOTE (IAN) is to give advisory, non-binding guidance to ACTUARIES or other PRACTITIONERS that they may wish to take into account when providing ACTUARIAL SERVICES in accordance with INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs) related to specific classification, recognition, and measurement issues arising for CONTRACTS with DISCRETIONARY PARTICIPATION FEATURES (DPFS) included in INSURANCE CONTRACTS and INVESTMENT CONTRACTS. The primary accounting standard describing the financial reporting treatment of these contracts is IFRS 4. This IAN applies where the REPORTING ENTITY is an ISSUER of insurance contracts, investment contracts, or SERVICE CONTRACTS.

Reliance on information in this IAN is not a substitute for meeting the requirements of the relevant IFRSs. Practitioners are therefore directed to the relevant IFRSs (see Appendix B) for authoritative requirements. The IAN refers to IFRSs that are effective as of 16 June 2005, as well as to those amended IFRSs not yet effective as of 16 June 2005 but for which earlier application is encouraged. If IFRSs are amended after that date, practitioners should refer to the most recent version of the IFRS.

2. Publication Date

This IAN was published on 16 June 2005, the date approved by the Council of the INTERNATIONAL ACTUARIAL ASSOCIATION (IAA) and updated on 28 March 2014.

3. Background

Appendix A of IFRS 4 defines a DPF. The treatment of insurance contracts with such features is described in paragraph 34 and for investment contracts with such features in paragraph 35. It is important that such features be carefully identified and classified, as they affect recognition, measurement, and disclosure.

In addition, it is important to distinguish insurance contracts with DPF from investment contracts with DPF, as they may need to be disclosed separately in the entity's FINANCIAL STATEMENTS.

The most frequently applicable IFRSs pertaining to this IAN are given in Appendix B. IFRS 4 and IAS 39 provide guidance for the recognition and measurement of insurance and investment contracts with DPFs, while IAS 32 provides guidance for the disclosure of investment contracts with DPFs. IAS 1 provides overall guidance regarding the presentation of general purpose financial statements for these instruments.

4. International Actuarial Note

4.1 Assessment of whether a contract contains a DPF

The accounting guidance defines a DPF as:

> A contractual right to receive, as a supplement to GUARANTEED BENEFITS, additional BENEFITS:
>
> (a) that are likely to be a significant portion of the total contractual payments;
>
> (b) whose amount or timing is contractually at the discretion of the issuer; and
>
> (c) that are contractually based on:
>
> (i) the performance of a specified pool of contracts or a specified type of contract;
>
> (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
>
> (iii) the profit or loss of the company, fund or other entity that issues the contract. (IFRS 4, Appendix A)

A DPF arises from a contractual right to receive additional benefits in addition to the guaranteed minimum payments as specified in the contract. Contractual rights may be enforceable legally or in some other way. Although the right to receive the additional benefits is defined by reference to the contract language, the amount or timing of benefits payable under this feature will not be guaranteed until the point at which the amount or timing of these benefits has been determined. It is important to clearly identify the DPF as this can affect the measurement of the contract.

Clause (a) in the definition includes the phrase "likely to be a significant portion of the total contractual payments." The key words are "likely" and "significant." The IFRSs do not define likelihood in terms of any specific probability threshold. The term "significant" may be interpreted in the same sense as in the definition of insurance contracts (see IAN, *Classification of Contracts*). However, both terms are normally relevant in this context. The more significant the additional benefits as a proportion of the total contractual payments, the lower the likelihood that would be needed for clause (a) to be satisfied. In normal circumstances, a mathematical assessment would not be needed. It can be reasonably expected that, in most cases, the situation is clear.

The determination of whether a contract contains a DPF may be based on the conditions that existed when the contract was first issued, although this may be reassessed at each reporting date. It may be the case that the proportion of additional benefit may change over time and, in the event of adverse experience, may be likely to be an insignificant proportion of the total contractual payment. This reduction in likelihood may not affect the assessment of whether a contract contains a DPF. Conversely, in certain situations, the proportion of additional benefits may become more likely to be a significant proportion of the total contractual benefit. In this situation, if the contract is then reclassified as containing a DPF, the implications for the change in measurement of the contract and the relevant disclosure may need careful consideration.

Clause (b) in the definition states that the "amount or timing is contractually at the discretion of the issuer." For example, if the additional benefit is determined by reference to realised gains from investments, but the issuer has discretion about the date of realising investments, then this feature would normally satisfy this clause. A further example may be the contractual right of the INSURER to determine, at its discretion, the timing of allocation of amounts to individual POLICYHOLDERS, even if such amounts are legally designated to be ultimately distributed to policyholders. The precondition is that the discretionary power is granted to the issuer by the contract (including cases where the terms of the contract legally grant the issuer that power), so that policyholders have a contractual right, but the issuer influences the amount or timing of the additional benefits by exercising its discretion.

The definition in IFRS 4 requires that the application of this discretion must be constrained contractually by one of the sub-clauses of clause (c). Although discretion in a contract with DPF may also be subject to some contractual, legal, regulatory, or competitive constraints, in making the judgment as to whether clause (c) applies, market or competitive constraints may be excluded. Amounts paid solely for market or competitive reasons, without any of the contractual rights for the policyholder to receive such amounts, do not normally meet the definition of a DPF (see 4.1.1).

Within the categories mentioned in the sub-clauses of clause (c), performance could be related to specific types of risk such as mortality, morbidity, expenses, or lapse risks. In all cases, the performance aspects would be specified in order to meet the accounting definition of DPF.

4.1.1 Universal life insurance and participating contracts

IFRS 4, BC162, states that the "definition of a DPF does not capture an unconstrained contractual discretion to set a 'crediting rate' that is used to credit interest or other returns to policyholders (as found in the contracts described in some countries as ‘universal life’ contracts). Some view these features as similar to DPFs because crediting rates are constrained by market forces and the insurer’s resources. The Board will revisit the treatment of these features in phase 2.”

Thus, the definition of DPF in IFRS 4 may exclude those contracts that are categorised as “universal life contracts” in certain jurisdictions if they do not meet the requirements of clauses (a), (b), and (c). For example, such a contract may not meet the requirements of clause (c) if the discretion to set crediting rates is not bound contractually to the performance of a specified pool of assets or the profit or loss of the company, fund, or other entity that issues the contract.

The same is true of certain forms of “participating contracts” because the amount of payments for those contracts is not constrained as required by clause (c). In this case, the contract would be treated as insurance or as a FINANCIAL LIABILITY depending on the significance of INSURANCE RISK.

4.1.2 Contracts containing switching features

As described in 4.10.6 of the IAN, *Classification of Contracts*, certain contracts may contain OPTIONS to switch between, for example, investment contracts without DPF and investment contracts with DPF. A difficulty in assessing the classification of the contract is when the contract is currently invested 100% in asset-linked funds. The mere presence of the option to change the type of contract may not be sufficient for a contract to be classified as something other than the option chosen at onset of the contract.

To demonstrate the likelihood that the contract will be converted by the policyholder to a form that would require different accounting treatment, showing historical evidence of conversion behaviour that such a right has been exercised or reviewing sales material may be relevant. In addition, it may then be necessary to demonstrate that the effect of the right is substantial, i.e. that the effect of the change is expected to be significant. This could be demonstrated easily if such a conversion is done early in the contract. It may be more difficult to demonstrate if such contracts convert late in the contract term.

4.2 Definition of guaranteed element

The “guaranteed benefits” are benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer. For purposes of IFRS 4, the GUARANTEED ELEMENT is an obligation to pay guaranteed benefits included in a contract that also contains a DPF.

The guaranteed benefits in such contracts are not subject to the *future* contractual discretion of the issuer. The guaranteed element of the contract is non-discretionary at the date of valuation, although this may have originated from a distribution to the policyholder on a discretionary basis.

Although the policyholder may exercise cancellation rights with respect to the guaranteed portion, such cancellation rights are not exercisable by the issuer. Cancellation by the policyholder may affect the amount of guaranteed benefits paid to the policyholder.

In most circumstances, unconditional rights should be clearly identifiable by the terms expressed in the contract.

The actual measurement of unconditional rights may not need to be a fixed amount in monetary terms but may be a variable amount, provided the policyholder has unconditional rights to such amounts.

According to IFRS 4.35(b), it may be necessary to apply IAS 39 to the guaranteed element for investment contracts. For that purpose, the guaranteed element is identified so that it forms a separate instrument that is a suitable basis for applying IAS 39.

The IAN, *Classification of Contracts*, refers to splitting a contract into COMPONENTS. The split of a contract into a guaranteed element and a DPF is not such a split, since the DPF need not contain all the features needed to qualify it as a stand-alone contract. It may require the contributions of the guaranteed element and may therefore be economically dependent on the guaranteed element. However, the guaranteed element would normally include any feature that would permit the guaranteed element to form a stand-alone contract.

4.3 Constructive obligations

IFRSs, and in particular IAS 37, require that CONSTRUCTIVE OBLIGATIONS be considered when measuring liabilities. The definition of constructive obligations is provided in the List of Definitions for IANs 3-12 and expanded upon in Appendix A. Accounting guidance does not distinguish between LEGAL OBLIGATIONS and constructive obligations in recognising liabilities, although IAS 37 does define legal and constructive obligations separately. Even though IFRS 4 does not provide any guidance regarding the treatment of constructive obligations, existing ACCOUNTING POLICIES may consider them. For some countries, issuers, or contracts, policyholder expectations may be legal obligations that can be legally enforceable; in others, they are constructive obligations. In some cases, it may be necessary for the practitioner to seek appropriate advice to determine the nature of the obligations under the contract.

Constructive obligations are relevant in the context of the measurement of contracts with DPF. Payments under constructive obligations within DPF contracts are normally subject to the discretion of the issuer to some extent, since constructive obligations often do not normally define the obliged amount in absolute terms. They may be shaped by policyholder expectations and the issuer's past actions as shown through such actions as illustrations to policyholders or specific current statements. The determination of whether a constructive obligation exists may change over the contract term.

The evidence that forms the basis of this determination should be documented and normally is dependent on the circumstances of the individual contract or more likely groups of similar contracts. The interpretation of a constructive obligation usually affects the measurement of liabilities, particularly for purposes of measuring the DPFs. However, the existence of a constructive obligation does not necessarily affect the determination of whether a DPF exists.

4.4 Combined recognition of the guaranteed element and the DPF

IFRS 4 considers two approaches that can be used to treat contracts with DPF: (1) combined recognition of the guaranteed element and the DPF; and (2) separate recognition.

IFRS 4.34(a) states that insurance contracts "may, but need not, recognise the guaranteed element separately from the DPF. If the issuer does not recognise them separately, it shall classify the whole contract as a liability." This is referred to in this IAN as "classification" of the contract rather than its "recognition" or "measurement."

In such a situation, the entire DPF (including the timing differences discussed in section 4.6 below) would be classified as a liability within the entire contract, rather than partially or entirely as equity.

In such a case, key features of IFRS 4 are applied to the entire contract. In particular, the LIABILITY ADEQUACY TEST would be applied to the entire contract. If a test under IAS 37 is required, then current or future rights of policyholders arising from DPF are considered as part of this test. For example, the cash flows for the liability adequacy test include any amount arising in the future under the assumptions of the liability subject to the DPF to comply with the requirement that the entire DPF is classified as liability.

IFRS 4.35(a) extends this approach to investment contracts that contain a DPF and states, "(a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraphs 15–19 to the whole contract, (i.e. both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying IAS 39 to the guaranteed element."

In this case, IFRS 4.9, 4.14–30, 4.34(a)–(d), and 4.35(c) are applicable to the contract. In addition, the issuer should apply IAS 32, except IAS 32.5–32, AG25–35. IAS 36.2(h) would not usually be interpreted in such a way that the exclusion applies only for insurance contracts but not for other contracts in the scope of IFRS 4. However, if the investment contract containing the DPF results in a FINANCIAL ASSET for the issuer, IAS 36 applies.

4.5 Separate recognition of the guaranteed element from the DPF

If the issuer recognises the guaranteed element separately from the DPF, i.e. evaluates the two independently, the considerations above apply. In addition, there are further considerations if the issuer reports a part of the DPF as a separate component of equity.

The issuer may recognise the guaranteed element independent from the DPF if it measures the guaranteed element separately from the DPF. IFRS 4 does not include a constraint regarding when or to what extent parts of the DPF may be recognised as a separate component of equity.

For insurance contracts, paragraph 34(b) states that the issuer:

> …shall, if it recognises the DPF separately from the guaranteed element, classify that feature as either a liability or a separate component of equity. This IFRS does not specify how the issuer determines whether that feature is a liability or equity. The issuer may split that feature into liability and equity components and shall use a consistent accounting policy for that split. The issuer shall not classify that feature as an intermediate category that is neither liability nor equity.

In addition, for investment contracts, IFRS 435(b) is applicable:

> (b) if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying IAS 39 to the guaranteed element. That amount shall

include the intrinsic value of an option to surrender the contract, but need not include its time value if paragraph 9 exempts that option from measurement at FAIR VALUE. The issuer need not disclose the amount that would result from applying IAS 39 to the guaranteed element, nor need it present that amount separately. Furthermore, the issuer need not determine that amount if the total liability recognised is clearly higher.

4.5.1 Some circumstances where it may be appropriate to recognise the guaranteed element separately

The guaranteed element may be recognised separately from the DPF. This split is not a requirement of IFRS 4 and such a split may not be appropriate in some circumstances but, in other cases, may best reflect the nature of the particular DPF. The approach chosen may be determined by the existing accounting policy. It may be appropriate to distinguish the guaranteed element, which is independent of the performance of the issuer, from a DPF that depends on the performance of the entity.

4.6 Assessment of whether any part of the DPF is classified as equity

If the guaranteed element is reported separately, IFRS 4 does not prohibit the recognition of part of or the entire DPF as a separate component of equity. In the case of an investment contract with a DPF, the IAS 39 measurement of the guaranteed part may need to be considered for the purpose of the liability adequacy test and whether to disclose this element separately.

The measurement basis of the DPF under IFRSs may be different from that used to determine actual benefits to policyholders (“DPF-basis”). This can result in timing differences between amounts reported under IFRS and those under the DPF-basis. For example, the IFRS-basis may include unrealised gains that have not been recognised on the DPF-basis. There may also be timing differences with respect to deferred ACQUISITION COST assets, deferred tax liabilities or assets, and other insurance related items. Such timing differences are similar to temporary differences between a financial statement prepared in accordance with IFRS and one prepared on a tax basis.

The amounts attributed in the balance sheet to a DPF include the relevant portion of any timing differences between the IFRS balance sheet and the DPF-basis balance sheet.

An issuer may have discretion to make voluntary allocations of future bonuses over and above policyholders’ rights. For example, this may arise in cases where the issuer chooses to pay extraordinary dividends to policyholders and makes it clear that such payments are not part of the ongoing rights of policyholders to receive such amounts in future. In this example, if the existing accounting policy allows the recognition of such an amount as liability, this accounting policy may continue, but on the other hand it may not normally be permissible to change to that accounting policy. It is important to clarify where policyholders' rights to additional benefits end and where further additional benefits over and above policyholders' rights begin.

4.6.1 Consequences of classifying parts of the DPF as equity

If any part of the DPF is recognised as equity, that part is presented as a separate component of equity. It may be necessary to provide further breakdown of this component of equity in accordance with IAS 1, particularly that aspect relating to "shadow accounting" under IFRS 4.30.

In addition, in the case of investment contracts, the total recognised net liability under the contract must comply with an additional adequacy test based on the application of IAS 39 to the guaranteed element in accordance with paragraph IFRS 4.35(b).

4.6.2 Applying IAS 39 to the guaranteed element for investment contracts with DPF

To apply IAS 39 to the guaranteed element, the guaranteed element would be separately identified and reliably measured. The measurement under IAS 39 would usually take account of the IAN, *Measurement of Investment Contracts and Service Contracts*.

The treatment of costs relating to future investment management services fees under IAS 18 is a separate consideration. However, margins required to amortise the asset representing the entity's contractual rights to benefit from future investment management services would not be double-counted. In other words, such margins would not also be used to reduce the liability under IAS 39.

IFRS 4 requires the inclusion of the "intrinsic value of an option to surrender the contract, but need not include its time value if paragraph 9 exempts that option from measurement at fair value." This may increase the minimum required amount. In measuring the guaranteed element at fair value under IAS 39, the result would be at least the amount payable on surrender (excluding any amount that may result from the DPF). If the guaranteed element was measured at AMORTISED COST under IAS 39, it may be possible or necessary to fair value the surrender option under the contract.

4.6.3 Determining whether the liability is clearly higher than the minimum required for an investment contract with DPF

The total liability for the contract is compared to the measurement that IAS 39 would apply to the guaranteed element if part of the DPF is reported as equity. The total liability includes that part of the DPF that has been classified as a liability. If it is clear that such the total liability is greater than that required under IAS 39 for the guaranteed element, then no further assessment is required.

Although such an assessment is supposed to be carried out at an individual contract level, in practice it is normally sufficient to group contracts of similar risk profile and characteristics when making the assessment. In addition, in some jurisdictions, the first step in the determination of the amount to be distributed is first based on overall performance or amount of contributed surplus; as such, it would be appropriate to perform at least this part of the analysis on an aggregate basis. It may be appropriate to use MODEL points if it can be demonstrated that the model points are representative of the group of contracts. Such assessments would be carried out at the reporting date.

For marginal cases, more model points may be necessary to demonstrate the assessment. However, it may be appropriate to apply IAS 39 to the guaranteed element for all contracts if the assessment is marginal.

It is normally worth identifying the scenarios or trigger points at which there may be a possibility that the total liability may be inadequate. If the identified scenario or trigger point did occur, then this would usually lead to an automatic reassessment of the adequacy of the total liability.

In making this assessment, any INTANGIBLE ASSET (for example, those relating to deferred acquisition cost asset) may be deducted from the liability amounts being considered as total liability of the contract.

The measurement of the guaranteed element under IAS 39 would usually be preceded by full application of all classification and measurement rules, as described in the IANs *Classification of Contracts* and *Measurement of Investment Contracts and Service Contracts*, including the split of the guaranteed element into separate SERVICE COMPONENTS and financial instrument components, and IAS 18 and IAS 39 applied respectively to these components. The phrase “the amount that would result from applying IAS 39 to the guaranteed element" in IFRS 4.35(b) may be understood as referring to the total net carrying amount resulting from the service and the financial instrument component.

If the liability reflecting part of the DPF is determined on a collective basis, then it would need to be allocated to individual contracts as expected to be allocated in future. However, if the issuer is free to use such amounts to cover losses arising from other individual contracts, then it may be appropriate to make the total assessment on a portfolio basis.

4.6.4 Measurement of a DPF

If the DPF is measured together with the guaranteed part, the existing measurement approach (unless modified by an acceptable change in accounting policy in accordance with IFRS 4.22 and, in such cases, the modified approach applies) determines the measurement basis. IFRS 4 does not constrain whether and to what extent parts of the DPF may be recognised as a separate component of equity if the guaranteed element is recognised separately from the DPF. This will be the reporting entity's choice, although in any case the applicable portion of the accounting policy adopted would be disclosed.

The measurement of the DPF is determined on the IFRS-basis. This also typically includes any allowance for the timing difference between the IFRS-basis and the DPF-basis. In this way, it is possible to ensure consistency between the recognition of payments from the DPFs on both the IFRS-basis and DPF-basis. If parts of the DPF resulting from timing differences are recognised as equity, it follows that part of the DPF has been classified as equity.

If there is a contractual obligation to allocate a minimum portion of the investment returns produced by assets held in funds identified by a DPF contract, the issuer will reflect that obligation as a DPF liability even if it continues to have the discretion to pay that amount to at least the liability holders. Any amount not classified as a liability may be classified as the equity component of DPF. This amount may be released from the equity component of DPF to other equity reserves when the issuer has exercised its discretion and the amounts have not been credited to the liability holders.

It may be appropriate to recognise, at a minimum, the liability for the contracts as the sum of the liability for the:

1. Guaranteed element; and
2. Legal and constructive obligations to existing policyholders under the DPF, although IFRS 4 does not explicitly require these obligations to be recognised as a liability.

When measuring the constructive obligations, it may be appropriate to project a gradual reduction or increase of any overpayment or underpayment, of current BENEFITS relative to the amount that are expected to be sustainable in the long-term. In addition, the minimum measurement under IAS 39 would normally reflect only obligations to current policyholders and excludes obligations to future policyholders.

The measurement of the liability is not affected by possible future additional benefits for which the issuer has no legal or constructive obligation at the reporting date.

As such, all of the DPF would not usually be classified as equity unless the entity can prove that it has no legal or constructive obligations under the DPF (see 4.3).

To determine which part is classified as a separate component of equity and which is classified as liability under IFRSs, the reporting entity may wish to consider consistency with a split that may have been made under another reporting basis. For example, if an entity has already split part of the DPF under an embedded value or U.S. GAAP basis, it may be appropriate to consider adopting the same approach for IFRSs. Nevertheless, under IFRS 4 a consistent approach is appropriate when reporting under IFRS.

If shadow accounting is used, the effect of unrealised capital gains/losses at the valuation date is reflected in the measurement of the DPF as if they were realised capital gains/losses.

4.7 Treatment of a negative measurement of the DPF

The measurement of the DPF may result in a negative amount under the IFRS-basis, for example, if there are cumulative unrealised losses and the policyholders participate in investment gains or losses. The actual treatment of such negative amounts will depend on the issuer’s existing accounting policies. For example, such a negative amount may be reflected in the same way as if it were positive. If the policyholders’ share of the negative measurement of the feature results in reductions in future payments to policyholders, then it may be appropriate to reduce the overall liability for each contract accordingly.

However, a negative amount would not be considered if the effect would be to reduce the measurement of any guaranteed elements.

In certain jurisdictions, it may be possible to consider the recognition of a separate asset to allow for the policyholders' share of the negative measurement under the issuers' existing accounting policy. In these cases, it will be necessary to consider carefully whether such assets meet the definition of an asset under the IASB *Framework* and should be recognised under IFRSs.

4.8 Revenue recognition

IFRS 4.34(c) states that the issuer:

> …may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the DPF classified as a liability shall be recognised in profit or loss. If part or all of the DPF is classified in equity, a portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to minority interests). The issuer shall recognize the portion of profit or loss attributable to any equity component of a DPF as an allocation of profit or loss, not as expense or income (see IAS 1).

Paragraph 35(c) extends this to investment contracts and states that, "the issuer may continue to recognise the premiums for those contracts as revenue and recognise as an expense the resulting increase in the carrying amount of the liability."

For investment contracts, deposits normally follow deposit accounting under IAS 39. However, as a practical compromise, the whole premium for any contract with DPFs may be reported as revenue if this is line with the accounting policy. Note that this treatment differs from the normal treatment of deposits for investment contracts under IAS 39.

Increases and decreases to the equity component of DPF may be presented as an allocation of the profit or loss for the year.

Appendix A – Constructive Obligations

IFRSs mention constructive obligations in several places. Examples include:

1. IAS 19.3(c). An example of a constructive obligation is where a change in the enterprise's informal practices would cause unacceptable damage to its relationship with employees.

2. IAS 19.18. Under some profit sharing plans, employees receive a share of the profit only if they remain with the enterprise for a specified period. Such plans create a constructive obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such constructive obligations reflects the possibility that some employees may leave without receiving profit sharing payments.

3. IAS 19.19. An enterprise may have no legal obligation to pay a bonus. Nevertheless, in some cases, an enterprise has a practice of paying bonuses. In such cases, the enterprise has a constructive obligation because the enterprise has no realistic alternative but to pay the bonus.

4. IAS 19.26(c). For example, a constructive obligation may arise where an enterprise has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

5. IAS 19.135. An enterprise may be committed, by legislation, by contractual or other agreements with employees or their representatives, or by a constructive obligation based on business practice, custom, or a desire to act equitably, to make payments (or provide other benefits) to employees when it terminates their employment.

6. IAS 34, paragraph B6. A bonus is anticipated for interim reporting purposes if, and only if, (a) the bonus is a legal obligation or past practice would make the bonus a constructive obligation for which the enterprise has no realistic alternative but to make the payments. …

7. IAS 37.10. A constructive obligation is defined as "an obligation that derives from an enterprise's actions where:

   (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and

   (b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities."

8. IAS 37.71 and 37.72. A PROVISION for restructuring costs is recognised only when the general recognition criteria for provisions are met. In this context, a constructive obligation to restructure arises only when an enterprise:

   (a) has a detailed formal plan for the restructuring identifying at least:
       (i) the business or part of a business concerned;
       (ii) the principal locations affected;
       (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
       (iv) the expenditures that will be undertaken; and
       (v) when the plan will be implemented; and
   (b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

9. IAS 37.75. A management or Board decision to restructure does not give rise to a constructive obligation at the balance sheet date unless the enterprise has, before the balance sheet date:

   (a) started to implement the restructuring plan; or
   (b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

10. IAS 37.78. Where a restructuring involves the sale of an operation, no obligation arises for the sale until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

11. IAS 37, Appendix C, Example 2(b). The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the enterprise has created a valid expectation on the part of those affected by it that the enterprise will clean up contamination.

Appendix B – Relevant IFRSs

The most relevant International Financial Reporting Standards and International Accounting Standards for this International Actuarial Note are listed below.

- IAS 1 (2001 April) Presentation of Financial Statements
- IAS 18 (2004 March) Revenue
- IAS 19 (2004 December) Employee Benefits
- IAS 32 (2003 December) Financial Instruments: Disclosure and Presentation
- IAS 37 (1999 July) Provisions, Contingent Liabilities and Contingent Assets
- IAS 39 (2004 March) Financial Instruments: Recognition and Measurement
- IFRS 1 (2003 December) First-Time Adoption of International Financial Reporting Standards
- IFRS 4 (2004 March) Insurance Contracts

In addition, the IASB *Conceptual Framework* is relevant.

Appendix C – Terms defined in the IAA List of Definitions for IANs 3-12

The first time that these terms are used in this IAN, they are shown in small capital letters. The definitions of these terms are included in the IAA List of Definitions for IANs 3-12.

Accounting policy
Acquisition cost
Actuarial Services
Actuary
Amortised cost
Benefit
Component
Constructive obligation
Contract
Discretionary participation feature
Fair value
Financial asset
Financial liability
Financial statement
Guaranteed benefits
Guaranteed element
IAA
Insurance contract
Insurance risk
Insurer
Intangible asset
International Accounting Standard (IAS)
International Accounting Standards Board (IASB)
International Financial Reporting Standard (IFRS)
International Financial Reporting Standards (IFRSs)
Investment contract
Issuer
Legal obligation
Liability adequacy test
Model
Option
Policyholder
Practitioner
Provision
Reporting entity
Service component
Service contract