

## STAFF PAPER

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## REG IASB Meeting

<b>Project</b>	<b>Insurance contracts</b>		
<b>Paper topic</b>	Insurance contract revenue - examples		
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Please note that this paper was reposted due to an error in the graph after paragraph 28. The only change is that the graph after paragraph 28 has been replaced.

This paper contains coloured graphs therefore it is advised to print this paper in colour.

**Purpose of the paper**

1. This paper has been provided as a background for Agenda Paper 2A *Insurance contract revenue*, and should be read in conjunction with that paper. This paper describes the mechanics for determining insurance contracts revenue as proposed in the 2013 Exposure Draft *Insurance Contracts* (2013 ED). This paper also illustrates the outcome of the insurance contracts revenue proposals for some types of contracts and illustrates the related disclosures.
2. This paper does not ask any questions.

**Structure of this paper**

3. This paper provides more detailed analysis of the proposal discussed in Agenda Paper 2A *Insurance contract revenue* that entities should recognise insurance contracts revenue in a way that is consistent across all insurance contracts and other contracts with customers.

- (a) It explains how insurance contracts revenue is determined in paragraphs 4-12.
- (b) It illustrates the outcome of proposals for a portfolio of life contracts, including:
  - (i) Explanation of amounts recognised in the statement of comprehensive income in paragraphs 13-29;
  - (ii) Explanation of disclosures related to proposed presentation in paragraphs 30-39;
  - (iii) Explanation of how proposed revenue could be used in the financial analysis in paragraphs 40-41.

***How insurance contract revenue is determined***

*Consistency with revenue from (non-insurance) contracts with customers*

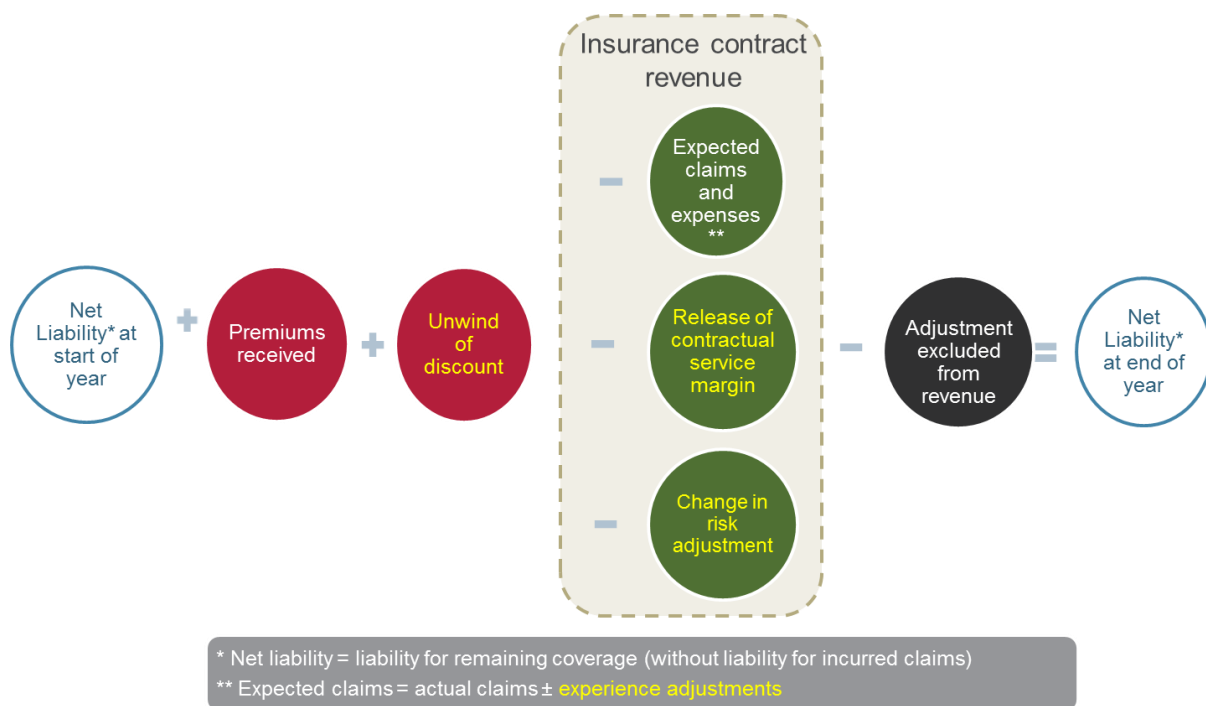
4. The 2013 ED proposed that an entity should present insurance contract revenue in a way that would be broadly consistent with the general principles in the 2011 Exposure Draft *Revenue from Contracts with Customers* (the Revenue ED). As discussed in the paragraph BC79 of the Basis for Conclusions to the 2013 ED, the principles for insurance contracts revenue are the same as for revenue from other contracts with customers. In both cases, the statement of financial position reports the contract asset or contract liability, and the statement of profit or loss and other comprehensive income reports the progress towards satisfaction of the performance obligations in the contract. However:
- (a) the Revenue ED establishes the amount of revenue that has been recognised each period and adjusts the contract asset or contract liability at the start of the period by the amount of revenue recognised to measure the contract asset or contract liability at the end of the period; and
  - (b) the 2013 ED proposes a measurement model that would establish the contract position at the start and end of the reporting period. The amount of insurance contract revenue presented is measured by reference to these two measurements.

5. Accordingly, insurance contract revenue, like revenue from other types of contracts with customers, would depict the transfer of promised services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the services. Thus, the proposed insurance contract revenue approach would allow for comparison of revenue information between different types of insurance contracts, and between insurance contracts and other types of contracts with customers.

*Determining insurance contract revenue by reference to the liability for the remaining coverage*

6. Applying the principle that insurance contract revenue should depict the transfer of promised services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the services means that the entity would:
- (a) recognise insurance contract revenue in each period as it satisfies the performance obligations (primarily bearing risk and standing ready to provide coverage) arising from the insurance contract; and
  - (b) exclude from insurance contract revenue (and expenses) any investment components, because the receipt (and repayment) of investment components do not relate to the provision of services to the customer.
7. In the 2013 ED, the IASB noted that insurance contract revenue can be mechanically measured using the change in the liability for the remaining coverage. This is because the liability for the remaining coverage represents the obligation to provide the remaining services needed to fulfil the contract. As a result, recognising insurance contract revenue at the amount of the reduction in the liability for the remaining coverage would depict faithfully the entity's performance in providing services for the period, provided that the liability for the remaining coverage is adjusted to eliminate changes that do not relate to the satisfaction of the performance obligation. Those adjustments:
- (a) would exclude from insurance contract revenue the part of the change in the liability for the remaining coverage that arises either from losses on initial recognition or subsequent losses (and any subsequent changes of those losses). Those losses could arise from the changes in expected cash flows and changes in risk.

- (b) it ensures that losses immediately recognised in profit or loss would not be recognised as part of revenue in the period but would rather be treated as an expense in a similar way as for onerous contracts.
8. The total amount presented over the duration of the contract would equal the premiums received for services, adjusted for the time value of money.
  9. The diagram below illustrates how insurance contract revenue could be determined using changes in the liability for the remaining coverage.



*Drivers of determining insurance contract revenue to be recognised in statement of comprehensive income for the period*

10. As can be seen from the diagram in paragraph 9, insurance contract revenue can also be expressed as the sum of:
  - (a) the latest estimates of the expected claims and expenses relating to coverage for the current period, excluding those amounts recognised immediately in profit or loss. That amount excludes any repayments of investment components included in those estimates of expected claims;

- (b) the amount of the risk adjustment<sup>1</sup> recognised in profit or loss in the period; and
  - (c) the amount of the contractual service margin recognised in profit or loss in the period.
11. The premium paid by the policyholder includes the following amounts that could not be determined directly from the change in the liability for remaining coverage:
- (a) amounts that relate to investment components. An investment component is defined as the amount that an entity is required to repay to the policyholder regardless of whether an insured event happens. An entity excludes such amounts from insurance contract revenue and claims incurred.  
Consequently, an entity would be required to exclude (i) any amounts paid at maturity or surrender of the policy, and (ii) the amount of cash surrender values that are implicit in amounts paid when an insured event happens.
  - (b) amounts that the entity charged to recover directly attributable acquisition costs. For the purpose of measuring insurance contract revenue, an entity allocates the part of the premium relating to the recovery of directly attributable acquisition costs over the coverage period in the systematic way that best reflects the transfer of services provided under the contract. The entity recognises an offsetting expense in the period (ie for the same amount that is included in insurance contract revenue for the period).
12. In the response to the 2013 ED, some constituents were concerned about how to determine insurance contract revenue if the pattern of expected claims or the coverage period is not known at inception of the contract. The staff think this concern is unfounded because an entity need consider only the latest estimations related to the expected claims used to measure the liability for remaining coverage in order to measure insurance contract revenue. Similarly, concerns that the amount of investment component might vary over time need not make it difficult to determine

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<sup>1</sup> In the 2013 ED, insurance contract revenue included all changes in the amount of risk adjustment. However, at its March 2014 meeting, the IASB decided that changes in risk adjustment related to future coverage would be recognized as an adjustment to the contractual services margin rather than recognized immediately in the profit or loss. Consequently, the amount of insurance contracts revenue for the period would be only related to the amount of risk released in the profit or loss for the period rather than total change in risk adjustment as proposed in 2013 ED.

insurance contract revenue, because the entity need consider only the amount of investment component paid or repaid in each period to determine the amount to exclude from insurance contract revenue.

***Illustration of amounts recognised in the statement of comprehensive income for simplified portfolio of life contracts***

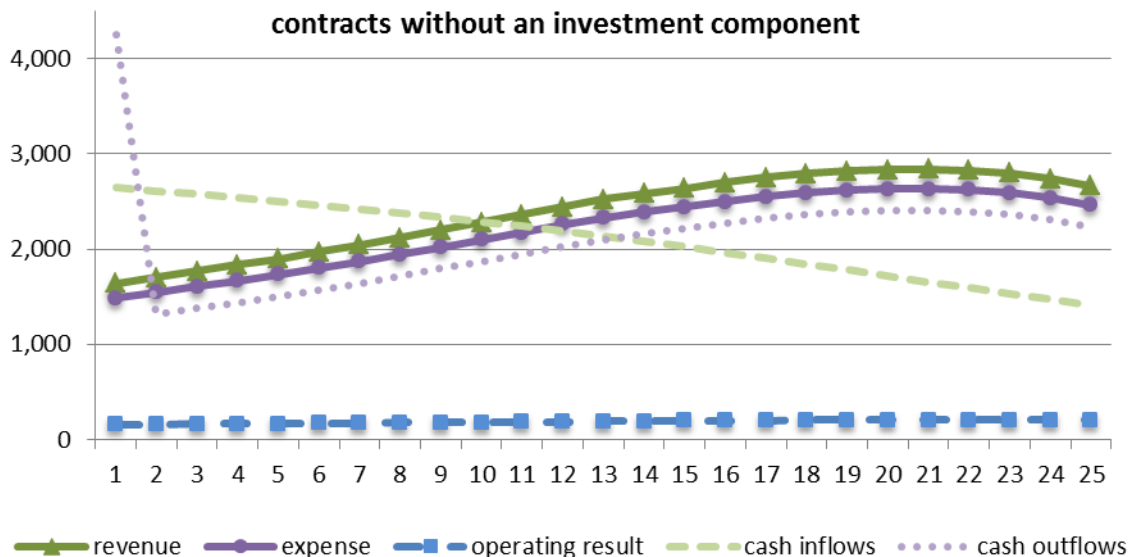
13. Insurance contract revenue as proposed by the 2013 ED is broadly consistent with the existing accounting for the simpler contracts that are eligible for being measured using the simplified measurement model. However, the presentation of insurance contract revenue would be a significant change compared to the amounts presented for long-duration contracts under existing accounting. Consequently, the staff have provided a simplified example that illustrates the recognition pattern of revenue for a portfolio of life contracts without participating features. The example illustrates 3 scenarios:
- (a) Example A sets out the base case;
  - (b) Example B modifies the base case to include an accumulated investment component in the contract;
  - (c) Example C adds to the Example B some changes in estimates after initial recognition.

***Example A: Base case***

14. This example considers the following fact pattern:
- (a) An entity has a portfolio of life insurance contracts covering the policyholder against risk of death during 25 years. There are no investment components (ie the entity does not promise to repay any amounts if an insured event does not happen during the coverage period).
  - (b) The policyholder pays annual level premiums and receives a benefit on death. The entity pays acquisition costs in year 1 and administration expenses each period. For simplicity, all expenses (claims and administration expenses) are paid when incurred.

- (c) The contracts are priced to be profitable (in the example around 45% of the expected profit is related to the compensation for risk and the remaining amount is related to non-risk related services).
  - (i) The risk adjustment is released when claims are incurred. There are no other changes in the value of the risk adjustment.
  - (ii) The contractual service margin is recognised in profit or loss as the service is provided. For simplicity, service is provided on a straight-line basis. Interest is accreted on the contractual service margin using the discount rate at the inception of the contract.<sup>2</sup>
- (d) Because the purpose of this example is to illustrate underwriting (operating) activity, the investment activity is omitted. In addition, the example assumes no change in the interest rate.
- (e) During the coverage period everything happens as expected and the entity does not change any assumptions.

15. The graph below illustrates what amounts an entity would report as insurance contract revenue and expense at the end of each period. For comparison purposes, the example also illustrates cash inflows and cash outflows for each period.



<sup>2</sup> The 2013 ED proposed that the interest on the contractual service margin should be accreted using the discount rate at inception of the contract. The staff plan to reconsider the rate used for accretion of interest on the contractual service margin at a future meeting.

16. The expenses reflect the amounts of the claims incurred, administration expenses and the amortisation of the acquisition costs for each period. All incurred expenses are paid immediately, therefore there is no significant difference between the cash outflows and the expenses incurred. The only difference is related to the amortisation of the acquisition costs that were paid at inception. Those acquisition costs are amortised in line with the pattern of the service provided. This amortisation means that there is a timing difference between when the costs were paid and when those costs are recognised in profit or loss. As a result, the total amount of acquisition costs recognised in profit or loss equals CU5.7k which comprises the at-inception payment of CU3.0k and interest accreted of CU2.7k.
17. The insurance contract revenue recognised in each period reflects the consideration to which the entity expects to be entitled in exchange for providing services in the period. Therefore it reflects the amount of consideration relating to the expenses of providing services (ie amount of claims, other expenses and the cost of bearing risk) and the profit the entity charges to provide those services. As a result:
- (a) In the example, the biggest component of the insurance contract liability relates to the expected claims, therefore the main driver for the recognition pattern for insurance contract revenue is the occurrence of claims.
  - (b) The calculation of revenue takes into account the difference between the time the service is provided (and revenue is recognised) and the time when the policyholder paid for that service. Often, premiums for insurance contracts are paid in advance, and services are provided in later periods. Consequently, the total revenue would equal the total cash inflows received at inception, adjusted to reflect the time value of money. In the example, the total revenue of CU59.8k comprises total premiums received of CU52.3k plus interest accreted of CU7.5k.

*Example B: contracts with an investment component*

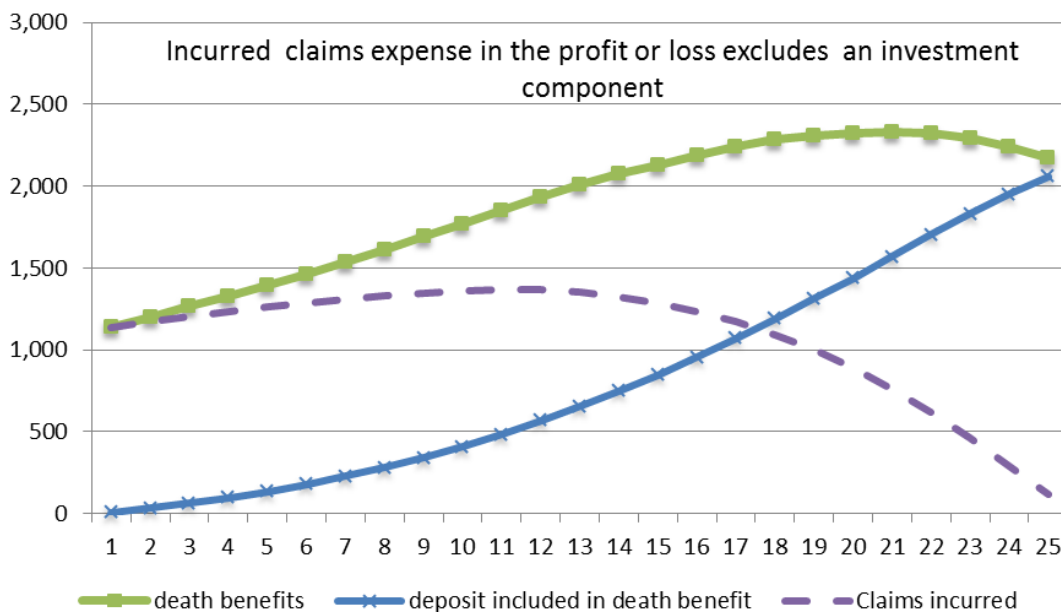
18. In the feedback to the 2013 ED, many constituents expressed concern that the proposal to exclude the investment component from revenue and claims would not provide useful information and would be complex to apply. To illustrate those issues



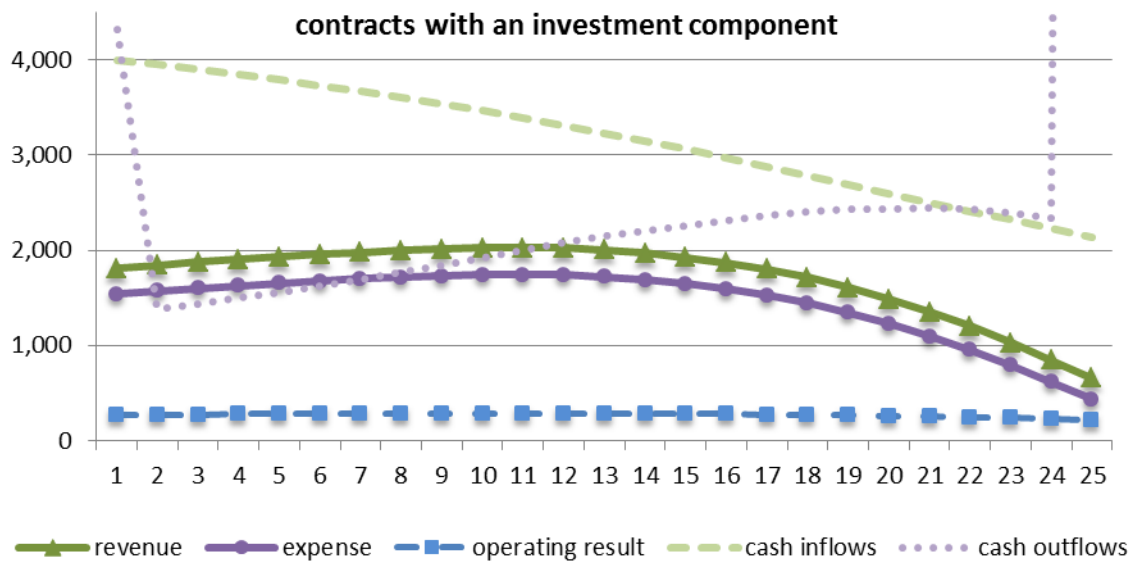
example B considers a portfolio of contracts that change the nature of the services provided from predominantly insurance protection to predominantly investment services over the coverage period because of the effect of an investment component. Example B shows how insurance contract revenue would reflect such a change.

19. Example B assumes that all basic assumptions are the same as in Example A, but:
  - (a) the contract additionally includes an investment component. An investment component is defined as an amount that the entity would be required to repay to the policyholder even if insured event would not happen. In this example, the investment component arises because of the promise to pay to the policyholder a cash surrender value if the policy is cancelled. That cash surrender value increases over the coverage period until it reaches the amount that would be paid at maturity to those who survived the coverage period. At each reporting period, the entity has a liability to the policyholder for the amount of the cash surrender value because the entity would be unable to avoid paying such amounts to the policyholder. This means that, when a death benefit is paid, the amount that was subject to insurance risk is only the additional amount that would be paid to the policyholder when an insured event occurs, and excludes the accumulated cash surrender value that was a liability to the policyholder in any case.
  - (b) Because of the additional promise related to investment component, an entity increases the annual premiums by around 50%. The contract is still priced to be profitable (around 20% of margin is related to the compensation for risk and remaining amount is related to non-risk related services).
  
20. The graph below illustrates the investment component included in the death benefit:
  - (a) The green line (death benefit) represents the total amount that the entity is required to pay when an insured event (death) happens. The total amount paid to policyholders on death is fixed. However, because there is an increase in mortality risk over time, ie the number of policyholders expected to die increases over time, the total amount of death benefit increases over time.

- (b) The blue line (investment component) represents the increasing amount of the accumulated investment component (cash surrender value) that the entity is required to pay if the policyholder cancels the policy at that date or dies. This amount increases because both the amount of cash surrender value per policyholder increases over time, and the number of policyholders that die increases over time.
- (c) The amount of claims expense presented in profit or loss is the excess amount (above the investment component amount) that the entity pays because the insured event happens. Consequently, the amount that is subject to insurance risk is the difference between total amount of death benefit and the cash surrender value (illustrated by the dotted purple line). The amount subject to insurance risk decreases over time because the proportion of the investment amount (prepaid by the policyholder) increases relative to the fixed amount of the total death benefit per each policyholder. In other words, the policyholder is prepaying more for his own death benefit over time.



21. The graph below illustrates what amounts the entity would report as revenue and expense at the end of each period.



22. The amount of insurance contract revenue in each period is the compensation the entity expects to receive for the services provided in the period. The repayment of the investment is not a service provided therefore insurance contract revenue excludes the repayment of investment from insurance contract revenue and expenses. This example illustrates that insurance contract revenue and expense amounts would indicate that, in this example, the amount of insurance service provided by the entity declines over time, and that the portfolio of contracts have different characteristics compared to those in Example A. It also reflects the different characteristics of the contract at different points in the coverage period, as follows:

- (a) At the beginning of the coverage period most of the payments on death are subject to the insurance risk and the investment component is low. The contract primarily provides insurance protection.
- (b) Towards the end of the coverage period, the amounts paid on death are mainly prepaid by the policyholder in earlier periods, and additional amounts due to the policyholder based on the insurance risk are low. The contract primarily provides an investment service.

23. As described in paragraph 18, many constituents are concerned about the complexity of excluding the investment component from volume information. For this example,

the amount of investment component repaid in each period would be the combined amounts from:

- (a) The component of death benefits that the policyholder would have been entitled to if the policyholder had surrendered the policy rather than died; and
- (b) Payments made when investment reach maturity.

24. The information in paragraph 23(a) is likely to be the only new piece of information that entities would be required to obtain, compared to their existing accounting practices. Such information could be calculated by most entities (because they would need to calculate it if the policyholder surrendered). However, many entities might not calculate that information within existing accounting systems but rather manually, particularly if the entity has discretion to modify cash surrender values. As a result, calculating this amount for many policyholders could add some complexity and cost to the model. Nonetheless, in the staff's view, entities should have access to the information needed to calculate the investment component amount in the death benefit. Such information might include, for example the amount of the cash surrender value for each policy separately. As a result, most entities should be able to estimate such amounts on an aggregate basis.

*Example C: contracts affected by the changes in the mortality assumptions*

25. Example C illustrates how insurance contract revenue would be affected by changes in assumptions, including changes in the investment component. To illustrate this aspect of the proposal, Example C uses the same assumptions as Example B, but adds a change in assumptions during the coverage period. Those changes in assumptions are as follows:
- (a) In year 13, the claims for the year are lower than expected.
  - (b) The entity concludes that this trend of lower mortality would continue in future periods and people would live longer.
26. Therefore the entity revises expectations about the future cash flows, as follows:
- (a) more premiums are expected to be received from the policyholders in each period. On the other hand more administrative expenses are expected to be

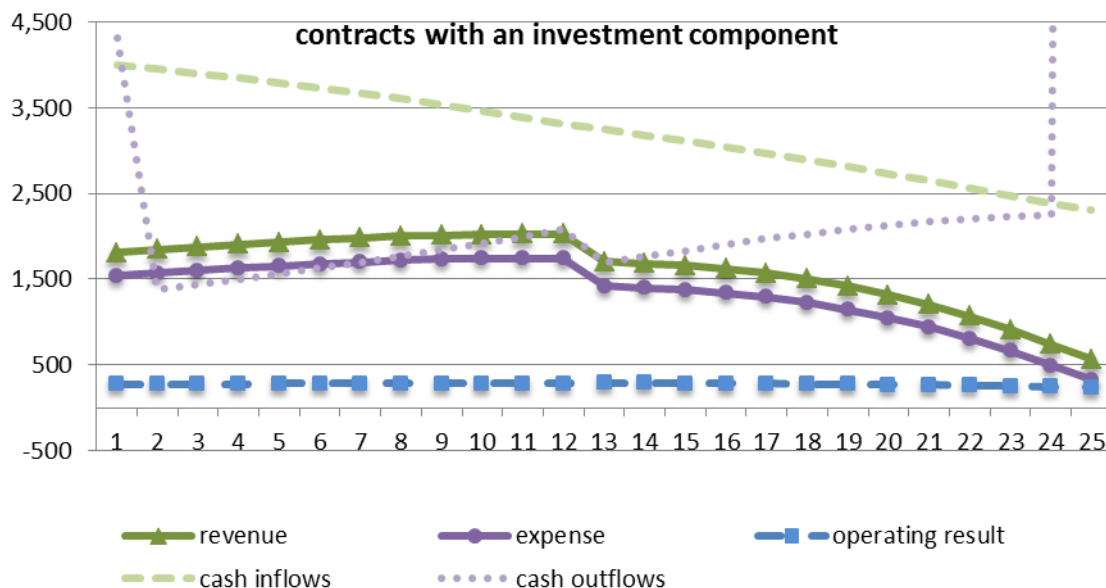
incurred related to more in-force contracts and greater amounts would be paid at maturity because more policyholders would survive to maturity.

- (b) fewer insurance claims are expected to be paid over the coverage period and consequently there is lower insurance risk for the entity.

27. In total, the change in assumptions causes a net increase in the expected future profit for non-risk related services as a result of:

- (a) maintaining the portfolio of contracts for longer than expected adds margin from the additional annual premiums, therefore increases expected future profit. The additional cash flows (related to the additional amount of premiums, the decrease of claims and greater amounts paid at maturity) offset each other and have little effect on the profitability; and
- (b) the decrease in risk adjustment (margin for risk) increased the expected future profit for non-risk related services<sup>3</sup>.

28. The graph below illustrates the amounts the entity would report as insurance contract revenue and expense at the end of each period.



29. Insurance contract revenue represents the amount that the entity charged for the services in the period. The change in mortality in year 13 and the following years

<sup>3</sup> In 2010 ED all changes were recognised immediately in the profit or loss. This adjustment reflects the tentative IASB decision taken during March 2014 meeting.

means that all payments to policyholders are paid later than originally expected, when the effect of the investment component in the contract is more significant.

Consequently, total insurance contract revenue is lower than expected because even though the profitability of the contract increased because the entity received more margin in new premiums, it was offset by the fact that the entity provided less insurance services than expected (in exchange for more investment services provided).

***Disclosures related to proposed presentation***

30. Agenda Paper 2A *Insurance contract revenue* explains the additional disclosures related to the volume information. The following section illustrates those disclosures for the chosen examples presented in this paper. Those disclosures are intended to:

- (a) explains the proposed amount of insurance contract revenue for each period (described in paragraphs 23-26 of the Agenda Paper 2A). As a result, entities would be required to disclose:
  - (i) a reconciliation of insurance contract revenue to cash inflows, which is currently used and well understood amount.
  - (ii) a reconciliation of insurance contract revenue to the inputs used to determine the amount (drivers of recognition pattern) such as: the expected incurred claims for the period (excluding investment components); expected incurred expenses and the acquisition costs that are allocated to the period; the amount of the risk adjustment and the contractual service margin recognised in profit or loss for the period.
- (b) meet the needs of users (described in paragraphs 27-41 of Agenda Paper 2A) by providing:
  - (i) Information about new business sold during the period. As a result, entities would be required to present separately the amount of the present value of expected cash inflows and cash outflows (with separate amount of acquisition costs), risk adjustment and contractual service margin. Such information could be used for assessing the effort of sales forces (if compared from period to period) in terms of volume, expected

profitability of new business (rationalising the acquisition costs spent in the period).

- (ii) Information about components of the insurance contract and changes in those components (those changes would result in similar information as proposed by the summarised margin presentation proposed in 2010 ED). As a result, entities would be required to disclose changes in present value of cash flows, risk adjustment and the contractual service margin recognised in profit or loss for the period. Such information could be used to understand how changes in the components of the insurance contract liability are translated to the amounts recognised in profit or loss.

31. These disclosures for Example C are illustrated below.

*Reconciliation of insurance contract revenue to cash inflows*

32. The table below illustrates the proposed reconciliation that explains the difference between the cash inflows in the period and the insurance contract revenue recognised in the period. The disclosure is presented for two periods at the beginning and two at the end of the coverage period.

<b>Reporting period</b>	<b>Year 1</b>	<b>Year 2</b>	<b>...</b>	<b>Year 24</b>	<b>Year 25</b>	<b>Total</b>
<b>Cash inflows</b>	<b>4,001</b>	<b>3,952</b>	<b>...</b>	<b>2,388</b>	<b>2,302</b>	<b>80,545</b>
Timing difference	(2,185)	(2,200)	...	(2,807)	57,715	0
Interest accreted	0	125		3,130	3,290	39,241
Investment component	(5)	(32)	...	(1,973)	(62,744)	(79,428)
<b>Total insurance contract revenue</b>	<b>1,811</b>	<b>1,845</b>	<b>...</b>	<b>738</b>	<b>563</b>	<b>40,358</b>

33. The main differences between the cash inflows and revenue for the period relate to:
- (a) Timing differences that arise because the cash inflows are often paid before the service is provided. There are two components to the timing difference:
    - (i) A recognition difference that arises because more insurance contract revenue is recognised towards the later years of the coverage period when the mortality risk is higher (because the recognition of revenue in this Example is mainly based on the timing of the occurrence of claims). This effect is shown in the line “timing difference”.
    - (ii) An accretion of interest on the amount of revenue to quantify the difference in timing between receipt of cash and provision of service.
  - (b) The exclusion of the investment component from the amount of revenue. That investment component increases over the coverage period. In year 25, the amounts repaid to the policyholder are mainly related to maturity payments.

*Reconciliation of insurance contract revenue to inputs used to determine revenue*

34. To explain the drivers of the insurance contract revenue recognised in the period, the table below illustrates the reconciliation of proposed revenue to the inputs that determine that revenue. The table illustrates disclosure for two periods at the beginning and two at the end of coverage.

<b>Reporting period</b>	<b>Year 1</b>	<b>Year 2</b>	<b>...</b>	<b>Year 24</b>	<b>Year 25</b>	<b>Total</b>
Expected claims	1,136	1,170	...	163	0	24,301
Expected other expenses	402	400	...	332	328	9,203
Release from risk	57	59	...	8	0	1,215



Release of contractual service margin	216	216	...	235	235	5,639
<b>Total insurance contract revenue</b>	<b>1,811</b>	<b>1,845</b>	...	<b>738</b>	<b>563</b>	<b>40,358</b>

35. The insurance contract revenue at the beginning of the coverage period is mostly related to the provision of insurance protection and therefore reflects mainly the occurrence and amount of the insurance claims (which excludes the investment component). In the later periods the services provided is mostly related to management of the investment, and the revenue is mostly determined by the administration expenses and profit from the non-risk related services.

*Information about new business*

36. To explain the new business written in a period, the table below illustrates the disclosure about expected cash flows and profitability at the beginning of the coverage period.

	CU
Present value of expected cash inflows	44,527
Present value of expected cash outflows,	(40,926)
out of which: total expected acquisition costs = 3,000	
Risk adjustment	(765)
<b>Fulfilment cash flows</b>	<b>2,836</b>
Contractual service margin (CSM)	(2,836)
<b>Liability recognised on balance sheet at inception</b>	<b>-</b>

37. The disclosure highlights that the contracts written in a period are expected to be profitable. It also highlights that the entity incurred acquisition costs of CU3,000 to acquire this new business. The disclosure about business written in a period is also useful:

- (a) when comparing profitability of the similar business currently in force or business written in previous years.
- (b) to assess the additional capital strain that the new business requires because of the additional risk exposure it brings to the entity.

*Reconciliation of insurance contract balances using the margin information*

38. The table below illustrates the information provided in the reconciliation of the insurance contract balances at the end of period 1. It shows the information about the changes in expected cash flows and margins and its effect on the amounts recognised in profit or loss for the period.

	<b>Insurance contract balance</b>	<b>Present value of expected cash flows</b>	<b>Risk adjustment</b>	<b>Contractual service margin</b>
<b>Opening balance</b>	-	<b>3,601</b>	<b>(765)</b>	<b>(2,836)</b>
Changes recognised in the underwriting result	273	-	57	216
Changes recognised in the investment result	170	376	(44)	(162)
Cash outflows	4,316	4,316	-	-
Cash inflows	(4,001)	(4,001)	-	-
<b>Closing balance</b>	<b>758</b>	<b>4,292</b>	<b>(752)</b>	<b>(2,782)</b>

39. The change in the insurance contract balance comprises the information about the cash flows in the period and changes in margins. Changes in margins explain the sources of the underwriting and investment result. In the example there were following changes:
- (a) The net amount of cash flows was related to the amount of premiums received, claims paid and the amount of acquisition costs paid,
  - (b) The underwriting result was related to:
    - (i) a release from risk mainly related to the occurrence of claims to which the risk is related to.
    - (ii) a release of contractual service margin (profit for non-risk related services) based on the straight line pattern; and
    - (iii) there is no change in cash flow that are recognised immediately through profit or loss (such as for example: experience adjustment or onerous contract).
  - (c) The interest income is related to the interest accretion on the components of the insurance contracts – in the first period, the interest on expected premiums is higher than interest on expected cash outflows.

### ***How proposed revenue could be used in financial analysis***

40. One advantage of the revenue for insurance contracts being comparable to the revenue for other types of contracts with customers is that different contracts can be more readily compared. In particular, revenue is often used to assess profitability in relation to other values, for example in ratio analysis.
41. Currently, users of financial statements place little weight on revenue-based ratios for life insurance contracts because the premium information provided are often not easily compared with expenses, and are not comparable between contracts and jurisdictions. A comparable and consistent measure of revenue might mean that users of financial statements of entities that issue life insurance might be able to obtain useful insights through analysis of typical non-life insurance ratios such as profit margin, combined ratio, expense ratio and claims ratios.