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Project **Insurance Contracts**

Topic **Presentation**

Purpose of this paper

1. This paper deals with the presentation of the statement of comprehensive income (hereafter performance statement). It is supplemented by examples in agenda paper 1E / FASB memorandum 51E.

Summary of staff conclusion

2. Although the staff sees merit in both an expanded margin approach and an approach that treats written receipts as revenue, some staff prefer an expanded margin approach while others prefer an approach that recognises written premiums as revenue, supplemented by the disclosure proposed in 24(c).

Structure of the paper

3. This paper is divided into the following sections:

    (a) Background

    (b) Key issue

    (c) What are the alternatives

    (d) Staff conclusions and recommendation

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Background

4. The core of the proposed insurance model is a direct measurement of the insurance liability; supplemented with an allocation over time of any day one gain. This issue also reminds us of a basic rule. This liability measurement drives the profit or loss (bottom line) reported in the performance statement for the insurance contract. This means that whatever the boards decide to do for presentation has no impact on profit or loss; it is purely a presentational matter.

5. The boards concluded in their February joint meeting that the presentation of the performance statement measurement should reflect the performance information generated by the measurement model. In other words, measurement drives presentation. To achieve this, the staff conclude that the performance statement should, at least, give the following information on the face of the income statement:

   (a) the release of the expected margin during the period flowing from the measurement model, showing the release of the risk adjustment separately from the release of the residual margin (although that split could be done either on the face of the income statement or in the notes).

   (b) the difference between the expected and the actual cash flows.

   (c) changes in estimates (remeasurements).

   (d) interest on insurance liabilities (ideally presented or disclosed in a way that highlights its relationship with interest on assets backing those liabilities).

6. To implement that, the boards decided to pursue an ‘expanded margin’ presentation. This presentation gives the information described in the previous paragraph and expands it with information on revenue and expenses. The basic principle is that it would calculate a ‘top-line’ revenue number by adding up the released margin and the claims and expenses other than those resulting from premium receipts expected to be paid back to the same policyholder. This is

illustrated in example 4 in agenda paper 1E (FASB Memorandum 51E). In that paper, we identified two ways of implementing an expanded margin approach:

(a) determine revenue by increasing the released margin in the period by estimated claims and expense amounts determined at inception of the contract. Those amounts were established when the insurer priced and issued the contract and should therefore be reasonably reflective of what the policyholder pays for the coverage under the contract (customer consideration). However, using amounts determined at inception means that the insurer would have to track historic information, which might be complex and onerous. Further, the insurer would also have to true-up those amounts to reflect the impact on the actual premiums of unanticipated changes in the number of contracts still in force (eg more lapses occurred than expected at inception). This approach is illustrated in example 4.

(b) determine revenue by increasing the margin released in the period by actual claims and expense amounts that occurred during that period. This is a less onerous approach because tracking of historic information would not be necessary. However, the number reported as revenue under this approach might become more disconnected from the actual customer consideration received from the policyholder. This approach is explained in paragraph 4 of the comments on example 4.

7. The expanded margin approach has the advantage that it shows the key performance information generated by the measurement (see paragraph 5). But it also shows 'volume information' about premium revenues and claims. Therefore, it can be integrated with the presentation for a simplified measurement (see paragraph 20), required for short duration contracts, and other activities by a conglomerate-insurer (banking, fund management).

8. However, applying an expanded margin approach results in a revenue number that is a computation rather than a direct reflection of the actual customer consideration received. To compute this number, one could try to keep this number as close to the actual customer consideration or, alternatively, use a

more practical approach based on current numbers. The former approach is likely to be quite onerous (eg, tracking of historic information). The latter approach may result in a number that is more disconnected from revenue and may give counterintuitive outcomes: if expenses go up, revenue would go up as well.

9. The issue of counterintuitive results came also up with respect to the IASB's tentative decision to recognise revenue at inception equal to the amount of acquisition costs (provided that the residual margin is sufficient to cover those costs). If in the example the acquisition costs had been CU25 instead of CU20, revenue recognised at inception would have increased by CU5 to CU25[1]. Some would also see the fact that as counterintuitive. However, the insurer can consider the acquisition costs in pricing, and subject to market conditions, may be able to recover them fully. Consider the following example

> Suppose an insurer sells through brokers at a premium of CU100, with cash flows (including risk adjustment CU90), and incurs acquisition costs of CU4. Suppose it also sells on the internet, incurring acquisition costs of CU1 and, and as a result, charges a premium of only CU97. In both cases, the residual margin on day one is CU6. But the insurer reports more day one expense and revenue in the case of the sale through the broker. This arguably is a reflection of the economics of the contracts.

Key issue

10. The challenges raised in the previous paragraphs are not new for this insurance contracts project. A presentation issue particularly comes up when thinking about how to combine the direct liability measurement with a more 'traditional' presentation of premium-based revenue amounts.

11. The proposed insurance contracts model is a direct liability measurement. This liability measurement drives the changes in carrying amount of the insurance contracts and reports those changes in profit or loss (as gains and losses).

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[1] An alternative considered by the IASB to treat the acquisition costs as a cash flow. However, this would in our view still result in the recognition of revenue on day one under an expanded margin approach.

Another example of a direct liability measurement is a fair value. Typically, IFRSs and US GAAP do not use these measurements in circumstances when it is important to report not just changes in measurements but also a 'top-line' revenue number that reflects consideration paid by the customer. (As a reminder, for insurance contracts, unlike for most other contracts with customers, the customer consideration is fixed at the outset and the cost of sales is highly uncertain and not known until after the coverage was provided. Insurance professionals sometimes describe this feature of insurance contracts as the 'inverted production cycle'.)

12. Other models report cash flows or allocations of cash flows in the performance statement. For example, the key element of the proposed revenue recognition model is to report the consideration paid by the customer as revenue. But it does not provide a direct measurement of the liability (unless a contract becomes onerous).

13. This distinction between reporting flows and changes in values is a key issue: how do we combine information about changes in value with information about flows, or perhaps even more challenging, allocations of flows. This poses the core problem for presentation: do we want to combine a direct liability measurement with a presentation of revenue and other flow items? And if we want to do so, how can we best achieve that? And if we don't, what are viable alternatives?

What are alternatives?

14. Two alternatives to an expanded margin approach that do not try to mix flow information with value information are:

    (a) A model that focuses on reporting written premium as revenue, with key performance information provided as part of disclosure.

    (b) A model that focuses on margins and other key performance information, as provided by the measurement approach. Volume

information would be provided through the statement of cash flows and through disclosure.

15. The former model noted in paragraph 14(a) simply recognises written premiums as revenue (similar to the revenue recognition for long-duration insurance contracts under US GAAP, which for many of these contracts recognises premiums as revenue when they are due). When the boards discussed the issue of composite margins during previous meetings, a presentation alternative along these lines came also up, linking cash flow information to the presentation in the statement of comprehensive income. That presentation would report as key items revenues (premium that are due) and expenses (benefits and claims incurred, including IBNR), as well as the effect of changes in estimates. Furthermore, it would show investment profit or loss[2]: Such a presentation model would resemble the written premium model (example 1 in paper 1E/FASB Memorandum 51E).

16. The criticism a written premium model receives is its lack of usefulness. This is largely caused by the fact that all the premiums, under IFRS reporting today often including the deposit component of the premium, go through revenue on a cash basis, offset by an amount presented as an expense that is generated by a corresponding change in insurance liabilities. Further, no performance information is given other than volume indicators.

17. The boards' proposals would deal with some of the issues raised by this approach. A deposit component, such as a policyholder account balance, would be unbundled and therefore be presented as a deposit receipt instead of as revenue. Further, the performance information as suggested in paragraph 5 can be provided through disclosures. An issue would still be that premiums are recognised as revenue on receipt rather than on the basis of performance over time. This means that, for example, a single premium received at the start of the

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[2] See May 2010, agenda paper 2C/FASB Memorandum 45C. This presentation was not necessarily limited to the composite margin discussion and is applicable to an approach that uses a risk adjustment (the risk adjustment would be included under *Change in estimates of cash flows* as part of (or perhaps separated from) *Benefits and claims*).

contract would be fully reported as revenue at that time. This would be inconsistent with the approach the boards have taken in their revenue recognition project.

18. The second alternative, an approach that fully focuses on reporting information on the value changes from the measurement, is the summarised margin approach in example 3 in paper 1E/FASB Memorandum 51E. This model is fully driven by the measurement approach and provides the key information that us lacking under many existing models, particularly for life contracts, on the face of the performance statement.

19. However, this model does not provide volume (or flow) information. This information would be provided by the cash flow statement or through disclosure. Further, the top-line, margin released during the period, is not consistent with the notion of revenue under the revenue recognition project. Also, this presentation arguably is difficult to integrate with other presentation formats that show revenue, such as the presentation for a simplified measurement and for fund management activities.

Presentation for a simplified measurement approach

20. The boards decided to require an allocation of the premium over the coverage period as a simplified measurement for the pre-claims liability for some short-duration contracts. In addition to whatever presentation model the boards select, for those short-duration contracts insurers would continue to report 'earned premiums' as revenue and incurred claims as an expense. The reported revenue number under this approach is consistent with the proposed revenue recognition model. Under many existing accounting models, such a presentation is combined with a traditional life presentation by:

    (a) reporting, as part of revenue, the premiums written, and

    (b) reversing out , often also as part of revenue, changes in the unearned part of written premiums for those contracts that are accounted under a premium allocation method (usually short-duration non-life contracts).

21. The boards could adopt the revenue recognition approach that reports premiums as revenue over time based on performance under the contract as part of the presentation model for the proposed insurance model. This would ensure that the reported revenue number would correspond to the customer consideration, recognised in a pattern consistent with the revenue recognition model, see example 2 in paper 1E/FASB Memorandum 51E. But this basically asks the insurer to apply two complete models: the proposed insurance contracts model for measurement purposes and a separate model solely for presentation purposes (ie to determine the amount presented as revenue). It seems overly costly and burdensome to ask insurers to apply two models. Moreover, for some types of insurance contracts, allocation of the premium or a part of that premium is inherently challenging (eg. immediate annuities and pure endowments). Further, if this approach were to be combined with a margin type presentation, a reconciling item is needed in the income statement to tie the allocated premium flows with the value changes from the liability measurement

Staff conclusions and recommendation

22. All the presentation alternatives mentioned in this paper have their pros and cons. None of the alternatives provides a clean solution overcoming all potential issues and difficulties.

23. Without a doubt, a summarised margin model provides the most natural fit for the proposed measurement approach for insurance contracts. But it would also result in a quite specific presentation model for these particular revenue-generating contracts with customers, not shared by presentation models used for other contracts for customers. It therefore seems difficult to use it as part of an income statement that that also reports non-insurance activities. Staff have not found a feasible way that combines the simplified margin approach with a simplified measurement and with the existing presentation for other activities that a conglomerate-insurer might have (banking, fund management).

24. A presentation model that reports written premiums would allow such integration. But it would also mean that measurement would not drive

presentation. Further, the reported revenue number may not fully meet the requirements of the revenue recognition model (although this might also be true under either of the margin approaches, and is true of existing approaches for some insurance contracts). If the boards were to select this approach, it would:

(a) report premiums as revenue on receipt. For this purpose, the premium would not include any deposit component that is unbundled. The part of the premium that needs to be accrued to cover future benefits is reported as an expense when the premium is due.

(b) report claims and expenses as incurred. Changes in expectations of claims and expenses, and differences between incurred claims and expenses and previous expectations are reported through the required reconciliation of changes in insurance liabilities.

(c) reconcile the income and expense items recognised in the performance statement with the items presented in the disclosure on the roll-forward of the insurance liability (this roll-forward shows for example cash payments and cash receipts, release of margins, changes in estimates and accretion of interest). The insurer should show this reconciliation in a way that highlights the released margin, experience, changes in estimates and interest accreted on insurance liabilities (ideally presented or disclosed in a way that highlights its relationship with interest on assets backing those liabilities).

25. The expanded margin presentation tries to overcome all those issues by combining information about revenue and claims with information about the release of margins. But it creates new issues. Most importantly, revenue will be an imputed number. That number might become disconnected from the actual customer consideration and deriving that number may require significant effort and additional procedures (like tracking of historic information). If the boards were to apply the expanded margin approach, they would have to decide whether to use the actual claims and expenses for the period or the 'historic' claims and expenses at inception for determining the amount reported as

revenue. As explained in paragraph 6, both approaches have pros and cons. Further:

(a) claims and expenses incurred during the coverage period should be added to the margin released. Any claims paid during the claims handling period are simply a settlement of those incurred claims (otherwise those claims and expenses would be double-counted, first as part of incurred claims and expenses during the coverage period and subsequently as claims paid during the coverage period).

(b) the margin released should not be increased by amounts that were paid back to the same policyholder as repayments of deposits. This is to keep the reported revenue line as close as possible to the actual consideration the customer pays for services (ie bearing risk) under the contract.

26. Staff acknowledges that a margin-based presentation, either summarised or expanded, best fits the proposed measurement approach to insurance contracts. But staff also notes the existence of issues that that make actual implementation of such a presentation approach challenging. In our view, the expanded margin presentation is the preferable of the two margin approaches because it better allows combination with accounting for other activities that insurers may undertake.

27. Staff believes that a presentation that reports premiums receipts as revenue, adjusted by a change in insurance liability for the accrued part of premiums and claims, provides an approach that raises fewer practical issues. But this presentation format is not driven by the proposed insurance measurement method (though disclosures proposed in paragraph 24(c) would fill this gap). We also acknowledge that the reported revenue would not fully meet the desirable characteristics of a performance reporting model for insurance contracts, as set out in paragraph 5. However, this is in our view an inherent consequence of trying to combine the proposed insurance contracts model with more familiar components of a traditional presentation model (and would, at least to a certain extent, be an issue for a margin-based presentation as well).

28. Although the staff sees merit in both an expanded margin approach and written premium approach, some staff prefer an expanded margin approach while others prefer an approach that reports written premiums as revenue, supplemented by the disclosure proposed in 24(c).

Question for the boards
Which approach to presentation do you prefer: a) an expanded margin approach b) an approach that recognises written premiums as revenue If you prefer a) an expanded margin approach, how would you like to implement that: a) by adding the actual claims and expenses incurred in the period to the margin released b) by adding the claims and expenses determined at inception, adjusted for changes of contracts still in force

APPENDIX A OVERVIEW OF PRESENTATION MODELS

A1. The alternatives for presentation of the performance statements we identified are:

(a) A pure 'flow' model. In other words, report cash receipts and cash payments, with an item that reconciles those cash flows with the value change from the liability measurement booked in profit or loss. In addition, performance information (like the information included in paragraph 5) is provided through disclosure. We also refer to this a presentation based written premiums. This model is also known as the 'traditional life model'. [Example 1 in paper 1E/FASB Memorandum 51E]

(b) A model that uses the flows as a basis, but allocates those flows over the life of the contract based on service provided to the policyholder. In addition, performance information (like the information included in paragraph 5) is provided through disclosure. This model is consistent with the proposed model in the revenue recognition project. It is also known as the 'traditional non-life model'. [Example 2 in paper 1E/FASB Memorandum 51E]

(c) A 'pure' (or summarised) margin approach that only displays the performance information, but does not display flows or allocations of flows. [Example 3 in paper 1E/FASB Memorandum 51E]

(d) Something that combines (a) or (b) with (c). This results in an expanded margin approach. Information on flows would be provided through other sources, like the cash flow statement and disclosures. We refer to this as an expanded margin approach. [Example 4 in paper 1E/FASB Memorandum 51E]

A2. A pure 'flow' model is simple in the sense that it simply books receipts and payments in the performance statement. It is also consistent with what many life insurers report today and gives volume indicators to users. But it has two main disadvantages. It is inconsistent with the revenue definition the boards adopted in their revenue recognition project, which requires that flows are reported as

revenue on the basis of performance under the contract. Under the 'flow' model, the top-line may have a certain 'lumpiness' based on when premiums are received. And it needs an income statement item that reconciles the flows with the value change from the liability measurement. This item can be quite big, particularly if deposit elements run through profit ors loss. This may impair the understandability of the performance statement; many users question the usefulness of this presentation. In a previous meeting, the boards tentatively rejected this model (we include it this paper though to make the boards aware of the full range of presentations that are available).

A3. A model that allocates the premium flows over the life of the contract could be seen as a variation on the previous model. It avoids 'lumpiness' of premiums. And if that allocation is done on the basis of performance under the contract (and if all deposit components are eliminated from the premium), this model would be consistent with the proposed revenue recognition model. However, the insurer would have to apply two measurements: a direct measurement of the liability and an allocation of flow amounts (premiums, claims). Put differently, it has to apply a direct measurement of a liability for measurement purposes and the revenue recognition model for presentational purposes. And it still requires a reconciliation between allocated flows ('earned' premiums and incurred claims) and the value change from the liability measurement.

A4. A 'pure' margin presentation avoids the problematic issue of what some might see as combining apples and oranges (flows and values). Presentation is fully focused on reporting the value change in the liability in a way that also shows the main drivers of performance. But under this approach the income statement will no longer show revenue as we know it from insurance today. And it will not show revenue as we know it from the revenue recognition project either. Furthermore, no information about claims and expenses will be shown on the face of the income statement. Finally, the question arises to what extent this presentation can be integrated with presentation formats that show revenue, such as the presentation for a simplified measurement and fund management activities.

A5. An 'expanded' margin approach combines the attributes of a flow model and a margin model. This means that it combines the advantages of two models. But it also means that it combines their drawbacks. An expanded margin approach shows revenues and claims, but at the same time it shows margin information. However, it also means that the two approaches are required, namely the direct liability measurement and the one for determining revenue. A practical alternative to implement the 'expanded' approach is to 'gross' up the reported margin for some or all expenses. That avoids the need to apply two separate measurements. However, this may mean that the revenue becomes an imputation, disconnected from what the actual customer consideration is. Furthermore, it may require costly and burdensome procedures to track historic information, depending on how this model is implemented.