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Project **Insurance Contracts**

Topic **Presentation examples**

Purpose of this paper

1. This paper presents examples of different possible approaches to the presentation of the performance statement for insurance contracts, in support of agenda paper 1D (FASB Memorandum 51D). The examples presented hereinafter are based on the same examples used in agenda paper 14E (FASB memorandum 39E) for the February 2010 joint meeting, with a few modifications (mainly to include acquisition costs).

2. The following fact pattern is designed to illustrate the presentation models discussed in this appendix. To focus on the style of presentation rather than on recognition and measurement, the examples are simple and all use the same fact pattern, as follows:

   (a) One thousand policies with a premium of CU1,000, paid 1 January and covering death between 1 January and 31 December. If the policyholders are still alive on 31 December, a maturity benefit is paid. (All numbers below are presented in CU1,000.)

   (b) At inception, the expected claims (including claims handling costs) are CU900.

      (i) Death benefits: expected value of CU50, to be paid on 30 June and of CU50 on 30 December.

(ii) Maturity benefits: expected value of CU800, to be paid on 31 December.

(c) Other expenses associated with the administration of the contracts are CU80, incurred evenly through the period.

(d) Expected investment return is 8 per cent and the risk free rate used to discount the liability cash flows is 5 per cent.

(e) Acquisition costs of CU20 incurred at inception of the contract.

(f) At inception, the insurer determines the expected present value of the cash outflows as CU935 and the risk adjustment as CU40. Further, it pays acquisition costs of CU20. Therefore, the residual margin at inception is CU5. The amount of risk and the risk adjustment are expected to decline evenly throughout the coverage period. The residual margin is also released evenly over the coverage period.

(g) At 30 June:

(i) the actual death benefits for the six months to that date are CU60.

(ii) the insurer estimates that the expected claims for the second half of the year will increase from the original estimate of CU50 by CU15 to CU65.

(iii) the insurer also increases its remaining risk adjustment by CU5 to CU25 because of an increase in the estimated quantity of risk associated with the remaining cash flows.

(h) For the six months to 31 December, the actual death benefits are CU75 (CU10 more than the expected value of CU65 as estimated at 30 June and CU25 more than the expected value of CU50 as estimated at inception).

(i) No differences between actual outcomes and previous estimates for other assumptions.

3. The examples have significant simplifications, for example no lapses. Furthermore, the examples assume that the effect of mortality experience on the

total amount of the maturity benefits is not material. Rounding differences may also exist.

4. The roll-forward of the insurance liability for each reporting period is as follows:

Liability Roll-forward

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Beginning	0	980	911
Cash movements			
Premiums received	1,000		
Claims and expenses paid		(100)	(915)
	1,000	(100)	(915)
Income and expenses			
Release of risk adjustments		(21)	(26)
Release of in residual margin		(2)	(2)
Interest accreted		25	23
Gains and losses on inception	(20)		
Experience adjustments		10	10
Changes in estimates		20	
	(20)	31	4
Total change in liability	980	(69)	(911)
Ending	980	911	0

Example 1 – Written Premium

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Premium revenue	1,000		
Investment income		39	37
Total income	1,000	39	37
Claims		60	875
Change in insurance liability	980	(69)	(911)
Expenses		40	40
Acquisition costs	20	0	0
Total expenses	1,000	31	4
Profit	0	8	33

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	980	919	41
Insurance liabilities	(980)	(911)	
Equity	0	8	41

Reconciliation with movements in Insurance liabilities

Total expenses included in measurement of insurance liabilities	980	31	4
Recognised premium revenue	1,000		
	(20)	31	4
Income and expenses			
Release of risk adjustments		(21)	(26)
Release of in residual margin		(2)	(2)
Interest accreted		25	23
Gains and losses on inception	(20)	0	0
Experience adjustments		10	10
Changes in estimates		20	0
	(20)	31	4
	0	0	(0)

Comments:

1. The whole premium is reported as revenue on receipt. The amount of acquisition costs of CU20 is recognised as an expense at inception of the contract, together with a change in the insurance liability.
2. If the contract were to include a policyholder account balance of an account-driven contract, a deposit component belonging to that account balance would be unbundled. In that case, revenue at inception would be CU238, equal to the total premium CU1,000 minus the deposit component CU762 (for this example determined as the expected present value of maturity benefits of CU800).
3. The changes in insurance liabilities show significant moments from a) accruing the premium received at inception and b) releasing the part of the liability that covers the maturity benefit at the end of the contract.

Example 2 – Allocated Premium

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Premium revenue	20	490	490
Investment income		39	37
Claims		60	875
Change in insurance liability		421	(421)
Expenses		40	40
Acquisition costs	(20)	0	0
Total expenses	20	521	494
Profit	0	8	33

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	980	919	41
Insurance liabilities	(980)	(911)	
Equity	0	8	41

Reconciliation with movements in Insurance liabilities

Total expenses included in measurement of insurance liabilities	-	521	494
Recognised premium revenue	20	490	490
	(20)	31	4
Income and expenses			
Release of risk adjustments		(21)	(26)
Release of in residual margin		(2)	(2)
Interest accreted		25	23
Gains and losses on inception	(20)	0	0
Experience adjustments		10	10
Changes in estimates		20	0
	(20)	31	4
	0	0	(0)

Comments:

1. The premium is recognised as revenue based on performance under the contract, which is evenly spread (allocated) over the life of the contract. Specifically,

under this approach the revenue line reports the amount of earned premiums. This is the result of the premiums written less any changes in unearned premiums.

2. The changes in insurance liabilities show significant movements because of the deposit element.

3. If the contract were to include a policyholder account balance of an account-driven contract, a deposit component belonging to that account balance wouldbe unbundled, as in example 1. This would have been reduced accordingly the premium revenue recognised over the life of the contract, and the corresponding change in insurance liability.

4. Acquisition costs of CU20 are recognised at inception of the contract as an expense and a corresponding amount of revenue is also recognised at inception to cover the amount of those costs.

Example 3 – Summarised Margin

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Risk margin		21	26
Residual margin		2	2
Insurance margin	0	23	29
Experience adjustment		(10)	(10)
Changes in estimates		(20)	0
Net gain at inception	0	0	0
Investment income		39	37
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	14
Profit	0	8	33

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	980	919	41
Insurance liabilities	(980)	(911)	
Equity	0	8	41

Reconciliation with movements in Insurance liabilities

Insurance margin		(23)	(29)
Experience		10	10
Changes in estimates		20	0
Interest on insurance liabilities		25	23
Total expenses included in measurement of insurance liabilities	0	31	4
Income and expenses			
Release of risk adjustments		(21)	(26)
Release of in residual margin		(2)	(2)
Interest accreted		25	23
Gains and losses on inception	0	0	0
Experience adjustments		10	10
Changes in estimates		20	0
	0	31	4
	0	0	0

Comments:

1. This format is similar to the analysis of changes in embedded value provided by many larger life insurers in the UK, Continental Europe, Australia, New Zealand, Canada and South Africa, and to the ‘sources of earnings analysis’ provided by some Canadian life insurers.

2. This format treats all premiums as deposits and all claims expense, claims handling expense and other contract-related expense as repayments of deposits.

3. The line labelled as insurance margin refers to the release of the margin from the start of the period to the margin at the end of the period. Thus, it represents the sum of:

   (a) the risk adjustment attributable to risk borne during the period, including the effects of interest accrued on the risk adjustment. The release during a period will also reflect unwinding of remeasurements in previous periods. In this example, the release for the second period of CU26 consists of the release for the period of the risk adjustment determined at inception (CU20), unwinding of the remeasurement at 30 June (CU5) and the interest accreted to the risk margin (CU1).

   (b) Release of the residual margin, including the effects of interest accrued on the residual margin.

   (c) It does **not** include the effect of remeasurements resulting from an **increase** in the estimated quantity of risk. The example includes this increase (CU5 at 30 June) in changes in estimates.

   (d) The experience adjustments show the difference between the expected cash flows included in the measurement (as determined at the beginning of the period) of the liability and the actual expenses during the period:

      (i) First half year: expected death benefits of CU50 versus actual death benefits of CU60.

(ii) Second half year: expected death benefits of CU65 (estimate at 30 June) versus actual death benefits of CU75.

(e) The income statement for the first half year shows changes in estimates of CU20 in total from the expected increases in expected claims (CU15) and risk adjustment (CU5) at 30 June 30 (remeasurements).

4. Acquisition costs of CU20 do not appear on the face of the performance statement as they are treated as a component of the repayment of the insurance liability, and are considered as any other cash outflows computed for the determination of the amount of the insurance liability at inception of the contract. If the acquisition costs were not fully recoverable at inception, a day one loss would arise.

Example 4 – Expanded Margin

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Premium revenue	20	113	114
Policyholder benefits		(50)	(65)
Expenses		(40)	(40)
Acquisition costs	(20)	0	0
Expenses incurred in this period, but already accrued in previous periods		0	20
Insurance margin	0	23	29
Experience adjustment		(10)	(10)
Changes in estimates		(20)	0
Investment income		39	37
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	14
Profit	0	8	33

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	980	919	41
Insurance liabilities	(980)	(911)	
Equity	0	8	41

Reconciliation with movements in Insurance liabilities

Insurance margin		(23)	(29)
Experience		10	10
Changes in estimates		20	0
Interest on insurance liabilities		25	23
Total expenses included in measurement of insurance liabilities	0	31	4
Income and expenses			
Release of risk adjustments		(21)	(26)
Release of in residual margin		(2)	(2)
Interest accreted		25	23
Gains and losses on inception	0	0	0
Experience adjustments		10	10
Changes in estimates		20	0
	0	31	4
	0	0	0

Comments:

1. The amounts shown as revenue are computed as the difference, allocated evenly over the two reporting periods, between:

   (a) the premiums of CU1,000, less the acquisition costs of CU20, and

   (b) the expected present value of maturity benefits determined at inception of CU762, plus

   (c) accretion of interest at the risk-free rate.

2. This example shows as revenue the part of the premium that the policyholder pays for risk-bearing services under the contract. That part is imputed at inception. In contrast, the summarised margin presentation in example 3 shows only the release of the margins and does not show a top-line revenue corresponding to the originally expected cash outflows plus the margin.

3. The second half year includes a release of benefits and expenses accrued in previous periods of CU20. This amount reflects the release of the amounts accrued at 30 June resulting from the remeasurement at that date of expected claims (CU15) and risk margin (CU5). The remeasurement of the insurance liability is recognised in profit or loss in the first half year.

4. Alternatively, the revenue amounts could be determined from updated amounts. In this case, the amount of the revenue line item would be the result of the grossing-up of the margin for expected claims and expenses, based on the latest assumptions, including those expected claims and expenses for which no premium was received. Therefore, in the second half year, the release from insurance risk and the amount corresponding to expenses already accrued in previous period of CU20 would have been included in the revenue line, resulting in revenue of CU134 (CU114+CU20).

5. In sum, in the six months to 31 December, the revenue of CU134 would be made up of the following amounts:

   (a) The revenue of CU114, plus

(b) The release of CU20 relating to expenses already accrued in previous period. This is in turn made up of:

(i) CU 15 of policyholder benefits already accrued at 30 June, but reported again as an expense in the six months to 31 December.

(ii) the release of an additional risk adjustment of CU5 recognised at 30 June, but for which no customer consideration was received.

6. However, note that the amount of CU20 was not consideration provided by policyholders, but it is a reversal of the remeasurement made at 30 June.

7. Another alternative would have been to report as revenue the whole premium. Under this alternative the reported revenue and cost items would be increased:

(a) the revenue line would have shown the total premium of CU1,000 (less the amount of CU20 covering incremental acquisition costs) allocated over the two reporting periods, including accreted interest;

(b) a reconciling adjustment of CU381 (50% of the entire deposit component of CU762) for the first period (expense) for part of the premium that is accrued for the maturity benefit to be paid at the end of the contract, with a release of that accrued amount in the second period.

8. The amounts shown for policyholder benefits and expenses are the expected value at the beginning of the period, not the actual amounts for the period (and not the amounts expected at inception). The difference between the amount expected at the beginning of the period and actual is presented as an experience adjustment.

9. Acquisition costs of CU20 are recognised at inception of the contract as an expense and a corresponding amount of revenue is also recognised to cover the amount of those costs.