30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **24 May 2006, London**

Project: **Insurance contracts (phase II) (Agenda Papers 4G, 4H, 4I)**

AGENDA PAPER 4G
BUSINESS COMBINATIONS AND PORTFOLIO TRANSFERS

Purpose of this paper

1. This paper discusses how phase II of the project on insurance contracts should address insurance contracts acquired in a business combination or portfolio transfer.

2. This paper does not discuss more immediate issues relating to insurance contracts that arise from the comment letters on the Business Combinations exposure draft. The Business Combinations team will bring these to the Board(s) in due course.

Summary of recommendations

3. This paper concludes the following:

   (a) IFRS 4 permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer. When the Board completes phase II of this project, if any significant differences remain between current exit value and fair value, it may be necessary to consider retaining the expanded presentation. If no significant differences remain, the expanded presentation will become redundant. (see paragraphs 4-9)

   (b) When an entity takes over a portfolio of insurance contracts in a portfolio transfer, the current exit value of the portfolio at that date is likely to equal the consideration

received, less the fair value of any other assets received (eg investments or recognisable intangible assets relating to customer relationships). If the current exit value is a different amount, the transferee should recognise the difference as income or expense. (see paragraphs 10-13)

Business combinations

4. IFRS 3 requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination. IFRS 4 does not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement (paragraphs 31-33 of IFRS 4 and paragraphs BC147-BC153 of the Basis for Conclusions, see appendix to this paper).

5. IFRS 4 permits, but does not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

   (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues.

   (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). The subsequent measurement of this intangible asset is required to be consistent with the measurement of the related insurance liability. Therefore, that asset is excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. However, IAS 36 and IAS 38 apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

6. The expanded presentation is also available for a block of insurance contracts acquired in a portfolio transfer.

7. The main purpose of the expanded presentation was to maintain the requirement to measure at fair value the identifiable assets and liabilities acquired, while permitting insurers to continue using existing measurement approaches for the insurance liabilities, so that insurers need not make systems changes that could become obsolete in phase II.

8. The Board has tentatively decided for phase II that:

   (a) insurance liabilities should be measured at current exit value, defined as the amount that the insurer would expect to have to pay today to another entity if it transferred all its remaining contractual rights and obligations immediately to that entity (and excluding any payment receivable or payable for other rights and obligations).

(b) it is too early to conclude whether current exit value is synonymous with fair value. The Board will review that question as work proceeds on the fair value measurement project.

9. If any significant differences remain between current exit value and fair value, it may be necessary to consider retaining the expanded presentation. If no significant differences remain, the expanded presentation will become redundant.

Contracts acquired in a portfolio transfer

10. Sometimes, an insurer acquires a portfolio of existing insurance contracts from the insurer that originally issued them. There are two main ways to effect a portfolio transfer:

    (a) The transferor may buy reinsurance that requires the reinsurer to indemnify the transferor for all cash outflows, and requires the transferor pass on all cash inflows to the reinsurer. In this case, the transferor still has the underlying liability, with a corresponding reinsurance asset (agenda paper 4D discusses reinsurance assets). The reinsurer has simply issued a reinsurance contract and would apply the same accounting model as all insurers issuing any kind of insurance contract.

    (b) The transferor arranges for its contractual rights and obligations to be transferred to the transferee (or to be cancelled, and replaced by new rights and obligations of the transferee.). This typically requires the consent of some or all of a regulator, a court or the policyholders.

11. In some cases, a portfolio transfer also involves the transfer of systems (which are sometimes highly specific to a particular portfolio) and staff. In such cases, the transferee would need to consider whether the transaction is a business within the scope of IFRS 3. It is beyond the scope of this paper to review the criteria that would be relevant for this assessment.

12. If the transferee acquires only the insurance contracts (and perhaps also the related investments), it is necessary to consider the relationship between the consideration for the transfer and the initial measurement of the insurance liabilities. In many cases, the consideration will, presumably, equal current exit value. If not, the transferee would need to consider first whether it has acquired recognisable intangible assets relating to the customer relationship.[1] After that intangible asset is recognised, any remaining difference (which may be rare) might be either:

[1] In this paragraph, customer relationship does not refer to the portion of the customer relationship included in the measurement of the liability (eg the expectation that policyholders will continue paying premiums for a long-term life insurance contract that

(a) recognised as goodwill

(b) included in the initial measurement of the liability, or

(c) recognised as income or expense.

13. It would not be representationally faithful to recognise goodwill if the transferee acquires nothing other than separately recognisable assets and liabilities (eg insurance liabilities, related reinsurance assets, investments, recognisable customer relationships, deferred tax). Moreover, including any difference in the initial measurement of the liability would be a departure from the principle of measurement at current exit value. Therefore, if any difference exists between the current exit value and the amount implied by the transaction price, the transferee should recognise that difference as income or expense.

provides guaranteed insurability). Instead, it refers to any additional customer relationship (eg the expectation that some policyholders will renew annual motor insurance contracts).

Appendix

Extract from the Basis for Conclusions on IFRS 4

BC147 When an entity acquires another entity in a business combination, IFRS 3 Business Combinations requires the acquirer to measure at fair value the identifiable assets and liabilities acquired. Similar requirements exist under many national accounting frameworks. Nevertheless, in practice, insurers have often used an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). Life insurers often describe this intangible asset by names such as the present value of in force business (PVIF), present value of future profits (PVFP or PVP) or value of business acquired (VOBA). Similar principles apply in non-life insurance, for example if claims liabilities are not discounted.

BC148 For the following reasons, the Board decided to permit these existing practices during phase I (paragraph 31 of the IFRS):

(a) One objective of phase I is to avoid prejudging most phase II issues and to avoid requiring systems changes for phase I that might need to be reversed for phase II. In the meantime, disclosure about the nature of, and changes in, the related intangible asset provides transparency for users.

(b) The IFRS gives no guidance on how to determine the fair value of the insurance liabilities, because that would be premature in phase I. Thus, fair values identified during phase I might need to be changed in phase II.

(c) It may be difficult to integrate a fair value measurement at the date of a business combination into subsequent insurance contract accounting without requiring systems changes that could become obsolete in phase II.

BC149 The intangible asset described above is generally amortised over the estimated life of the contracts. Some insurers use an interest method of amortisation, which appears appropriate for an asset that essentially comprises the present value of a set of contractual cash flows. However, it is doubtful whether IAS 38 Intangible Assets would have permitted its use. Therefore, the Board decided that this asset should remain outside the scope of IAS 38 and its subsequent measurement should be consistent with the measurement of the related insurance liability (paragraph 31(b) of the IFRS). Because this asset would be covered by the liability adequacy test in paragraphs 15-19, the Board also excluded it from the scope of IAS 36 Impairment of Assets.

BC150 IAS 36 and IAS 38 still apply to customer lists and customer relationships reflecting the expectation of contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination. An illustrative example published with IFRS 3 deals with customer relationships acquired together with a portfolio of one-year motor insurance contracts.

BC151 Measurements of the intangible asset described in paragraph BC147(b) sometimes include future investment margins. Those margins are subject to the same requirements as future investment margins included in the measurement of the related insurance liability (see paragraphs BC134BC144).

BC152 In some cases, an insurer's accounting policies under previous GAAP (ie those used before it adopted IFRSs) involved measuring the intangible asset described in paragraph BC147(b) on a basis derived from the carrying amounts of other assets and liabilities. In such cases, if an entity changes the measurements of its assets and liabilities on adopting IFRSs for the first time, shadow accounting may become relevant (see paragraphs BC181-BC184 for a discussion of shadow accounting).

BC153 Some respondents requested an exemption from fair value measurement for insurance liabilities assumed in a business combination. They argued that there is still too much uncertainty about how fair value should be defined and determined. However, insurers have apparently been able to cope with the existing requirements in IFRSs and in national standards. The Board saw no compelling reason for a new exemption.

AGENDA PAPER 4H
POLICYHOLDER PARTICIPATION RIGHTS

Purpose of this paper

1. The purpose of this paper is to seek clarification of one aspect of the Board's decision in March:

Summary of recommendations

2. This paper recommends the following:

   (a) the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders.

   (b) the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.

3. The paper also asks the Board to confirm whether the notion of an enforceable constructive obligation is the most appropriate test to determine whether an insurer should recognise a liability relating to expected dividends to participating policyholders.

Background

4. In March, the Board decided the following (emphasis added to highlight the points discussed in this paper):

   (a) Policyholder participation rights do not create a liability until the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders, current or future. More specifically:

(i) If participating policyholders have a prior claim on distributions of economic benefits generated by a pool of contracts and related assets, that fact does not, by itself, oblige the insurer to transfer those benefits to policyholders. Therefore, an insurer should not recognise that prior claim as a liability, unless some other factor creates an obligation.

(ii) A dividend scale approved by the regulator creates an obligation. The staff will investigate whether the insurer should measure that obligation using the dividend scale currently in force, or develop estimates of the dividend scale that would apply in each cash flow scenario.

(iii) To the extent that no unconditional obligation exists, an insurer should not recognise a liability in respect of expected transfers of economic benefits to policyholders. If an unconditional obligation comes into existence subsequently, the insurer should recognise the resulting liability and an expense at that time.

(iv) **In assessing whether an insurer has a constructive obligation to pay dividends to participating policyholders, the Board will rely on the definitions being developed in its conceptual framework and IAS 37 projects.** The Board decided in February 2006 that an equitable or constructive obligation can be a liability only if it **legally or equivalently compels** potential outflows of cash or other economic resources.

(v) Policyholder participation rights should not be regarded as the equity component of a hybrid contract (similar to convertible debt). Accordingly, no part of the premium should be regarded as proceeds received for issuing an equity instrument, **dividends to participating policyholders are an expense, not a distribution of profit and the face of the income statement need not distinguish profit or loss attributable to equity holders of the insurer and profit or loss subject to prior claims of policyholders. However, the insurer should disclose the fact that part of its equity is subject to those prior claims.**

(vi) Identical requirements should apply to shareholder-owned insurers and mutuals.

(vii) Participation rights in investment contracts should be treated in the same way as participation rights in insurance contracts.

Example

5. We illustrate with the following example. As always, we have simplified facts to restrict the example to the most relevant features for the question we are considering. As a result, the example is artificial. Insurer A issues participating insurance contracts, with the following features:

   (a) Each policyholder pays a single premium of CU 1,000 on 1 January.

   (b) If the policyholder dies in the next two years, the contract pays a death benefit of CU 20,000.

   (c) The contract ends after two years. If the policyholder survives to the end of the second year, there is no fixed maturity benefit, but the policyholder is eligible to receive a dividend if the insurer declares one. The insurer has typically paid policyholder dividends of around 90% of the surplus attributable to maturing contracts and, at the same time paid a dividend of around 10% of that surplus to shareholders. The insurer expects this practice to continue for the foreseeable future. However, the insurer believes it has no enforceable legal or constructive obligation to pay any benefit whatsoever to policyholders or shareholders.

   (d) The insurer issues 1,000 contracts on each of 1 January x2, 1 January x3 and 1 January x5. On 1 January x4, the insurer issues 1,800 contracts.

   (e) 1% of the original number of policyholders die each year. For example, for contracts that started on 1 January x2, 10 policyholders die in x2 and 10 die in x3. For contracts that started on 1 January x4, 18 policyholders die in x4 and 18 die in x5.

   (f) There are no lapses, acquisition costs, running costs, taxes, or differences between actual experience and previous estimates. Investment returns and risk margins are ignored.

6. The following tables summarise the insurer's balance sheet, income statement and cash flows, applying the staff's understanding of the Board's decisions in March (all figures in CU'000):

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder dividends	(540)	(540)	(972)
Profit	60	540	(372)

Changes in equity

	x3	*x4*	*x5*
Opening equity	600	600	1,080
Profit	60	540	(372)
Shareholder dividends	(60)	(60)	(108)
Closing equity	600	1,080	600

Cash flow statement

	x3	*x4*	*x5*
Premiums	1,000	1,800	1,000
Death benefits	(400)	(560)	(560)
Policyholder dividends	(540)	(540)	(972)
Shareholder dividends	(60)	(60)	(108)
Net cash inflow (outflow)	0	640	(640)
Opening cash	800	800	1,440
Closing cash	800	1,440	800

7. There are two striking things about this example:

   (a) Insurer A collects premiums in the first year of the contract but expects to pay some of the premiums back to policyholders in the second year. Nevertheless, the insurer does not recognise as a liability the dividends it expects to pay to policyholders.

   (b) The insurer recognises profits in one period, followed by losses in another period.

8. We can see these effects most clearly by looking at the contracts issued in x4. For these contracts:

   (a) Insurer A collects CU 1,800 at the start of x4, pays benefits of CU 360 in each of x4 and x5 and repays CU 972 to policyholders at the end of x4. This leaves CU 108 available as a dividend for shareholders. At the end of x4, although insurer A expects to pay policyholders CU 1,332 (death benefits of CU 360 plus dividends of CU 972) it recognises a liability of only CU 360.

   (b) In x4, insurer A recognises revenue of CU 1,800 and expenses of CU 720 (actual death benefits of CU 360 for x4 and expected death benefits of CU 360 for x5), leading to a profit of CU 1,080 from these contracts. In x5, insurer A recognises a

loss of CU 972 on these contracts. The profit of CU 1,080 in x4 comprises the CU 972 that insurer A expects to return to policyholders in x5 and CU 108 profit for the shareholders.

9. In the staff's view, constituents are likely to have concerns that this method of accounting:

   (a) includes in equity amounts that the insurer expects to return to policyholders.

   (b) results in profits (potentially large profits) at inception, with predictable losses in later periods when dividends are paid. These effects would balance out in aggregate if the insurer is in a steady state. However, if the insurer is contracting, or expanding, or fluctuating in size, the effects will not balance out.

   (c) relies on an insurer's ability to determine whether an enforceable constructive obligation exists. In many cases, this may be highly judgemental and dependent on estimates of the likely effect of litigation and regulatory intervention for which there is little or no case law precedent. Indeed, it is possible that some insurers could conclude that part of the expected policyholder dividends gives rise to an enforceable constructive obligation and part does not. Furthermore, that assessment could change from period to period.

   (d) assumes that the insurer could retain indefinitely surplus that policyholders expect to be distributed to them. In practice, if an insurer did not, without good reason, pay any dividends to participating policyholders, the insurer would not attract new business. Moreover, in some cases, although an insurer might not have an enforceable obligation to pay dividends out of a continuing operation, a cessation of new business might trigger an enforceable obligation to pay dividends to the remaining policyholders.

10. The appendix to this paper illustrates how this example would look using three alternative approaches that the Board rejected in March:

    (a) Highlight, on the face of the balance sheet and income statement, the portion of equity and profit that is expected to be returned ultimately to policyholders.

    (b) Use split accounting, similar to IAS 32's treatment of compound instruments, such as convertible debt.

(c) Include in the measurement of the liability all cash flows that are expected to go ultimately to current or future policyholders.

11. The papers for the March meeting considered the arguments for and against these alternative methods. This paper does not repeat the arguments.

Staff recommendation

12. In the staff's view, it is important to provide transparency about the extent to policyholders have prior claims on amounts recognised in equity. For many insurers issuing participating contracts, the amounts subject to these prior claims are far more material than minority interests and should be subject to at least as much transparency. Therefore:

    (a) the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders.

    (b) the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.

13. The staff has some concern that, in the specific case of participating insurance contracts (and participating investment contracts) it may be particularly difficult to assess whether an insurer has an enforceable constructive obligation to pay dividends, and that attempting to draw this distinction may not result in more useful information for users. The staff asks the Board to confirm whether the notion of an enforceable constructive obligation is the most appropriate test to determine whether an insurer should recognise a liability relating to expected dividends to participating policyholders.

Appendix

Example – other methods

Alternative method 1: highlight policyholder equity

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Analysis of equity on the face

Policyholder equity	540	972	540
Shareholder equity	60	108	60
Total equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder dividends	(540)	(540)	(972)
Profit	60	540	(372)

Analysis of profit on the face

Policyholder profit	-	432	(432)
Shareholder profit	60	108	60
Total profit	60	540	(372)

Notes:

1. Policyholder profit in x4 is the policyholder equity at the end of x4 (CU 972), less the policyholder dividend of CU 540.

2. Shareholder profit is higher in x4 than in x3 and x5 because more contracts were issued. (In this example, risk margins were excluded for simplicity, and the time value of money was ignored. As a result, in this artificial example, all shareholder profit is recognised in the first year.)

Changes in equity

	x3	*x4*	*x5*
Opening equity	600	600	1,080
Profit	60	540	(372)
Shareholder dividends	(60)	(60)	(108)
Closing equity	600	1,080	600

Alternative method 2: classify expected policyholders dividends as a liability

Balance sheet

		x3	*x4*	*x5*
Cash		800	1,440	800
Policyholder	liabilities:	(200)	(360)	(200)

guaranteed benefits			
Policyholder liabilities: participation benefits	(540)	(972)	(540)
Equity	60	108	60

Income statement

	x3	*x4*	*x5*
Revenue	1,000	1,800	1,000
Policyholder benefits	(400)	(720)	(400)
Policyholder participation	(540)	(972)	(540)
Profit	60	108	60

Changes in equity

	x3	*x4*	*x5*
Opening equity	60	60	108
Profit	60	108	60
Shareholder dividends	(60)	(60)	(108)
Closing equity	60	108	60

Alternative method 3: split accounting

Balance sheet

	x3	*x4*	*x5*
Cash	800	1,440	800
Policyholder liabilities	(200)	(360)	(200)
Equity	600	1,080	600

Analysis of equity

Policyholder equity	540	972	540
Shareholder equity	60	108	60
Total equity	600	1,080	600

Income statement

	x3	*x4*	*x5*
Revenue	460	828	460
Policyholder benefits	(400)	(720)	(400)
Profit	60	108	60

Changes in policyholder equity

	x3	*x4*	*x5*
Opening	540	540	972
Proceeds of new contracts	540	972	540
Policyholder dividends	(60)	(540)	(972)
Closing	540	972	540

Changes in shareholder equity

	x3	*x4*	*x5*
Opening	60	60	108
Profit	60	108	60
Shareholder dividends	(60)	(60)	(108)
Closing	60	108	60

AGENDA PAPER 4I
CHANGES IN INSURANCE LIABILITIES

Purpose of this paper

1. This paper discusses the following issue: When (if ever) should an insurer recognise premium receipts as revenue and when (if ever) should an insurer recognise them as deposit receipts?

2. At a later meeting, the Board may need to consider whether an insurer should be required to present separately any specified components of the changes in the carrying amount of insurance liabilities. The Board is considering similar issues in other projects, notably in its work on financial instruments and on performance reporting.

Summary of recommendations

3. The staff recommends the following:

   (a) For shorter duration non-life contracts with a coverage period of no more than about one year, an insurer should recognise all premiums as revenue when earned, after unbundling any deposit component that is not closely related to the underlying insurance exposure. The staff will consider possible criteria for such unbundling when the FASB receives responses to its forthcoming invitation to comment on risk transfer.

   (b) For all other insurance contracts, the Board should decide after the Discussion Paper to adopt one of the following, when the Board will have the benefit of responses to the IASB Discussion Paper on insurance contracts and to the FASB Invitation to Comment on insurance risk transfer:

      (i) require an insurer to treat all premiums, or

      (ii) require an insurer to unbundle all insurance contracts

Background

4. The premium for an insurance contract could be viewed as made up of payments for the following:

   (a) The expected present value of payments to the small proportion of policyholders who incur insured losses.

(b) Acquisition costs and the expected present value of other expenses.

(c) A margin for bearing risk and providing other services.

(d) If applicable, the expected present value of repayments to the same policyholders who paid the premiums (examples: annuities, endowments, some finite reinsurance contracts, some group insurance contracts). In substance, this component is a deposit. Significant deposit components are found in many longer term insurance contracts, particularly, but not exclusively, in life insurance.

5. This paper concentrates on the presentation the portion of the premium that relates to the deposit component. Five possibilities could be considered:

(a) Treat all premiums (including the portion that pays for the deposit component) for all insurance contracts as revenue.

(b) For insurance contracts that meet specified criteria (perhaps life insurance contracts, or long duration contracts), treat all premiums for all contracts as deposits. For all other insurance contracts, treat all premiums (or perhaps all earned premiums, rather than written premiums) as revenue.

(c) Permit insurers to choose for each class of insurance contracts between a revenue presentation and a deposit presentation, perhaps subject to some constraints.

(d) For presentation in the income statement (even if not for recognition and measurement), unbundle some (or specified) insurance contracts into a deposit component and an insurance component.

(e) Treat all premiums for all insurance contracts as deposits, and all claims and expenses as repayments of deposits.

6. Comments on these approaches:

(a) It would be inconsistent with the presentation of other kinds of activities (for example deposit taking by banks, or investment management by fund managers) to present deposit receipts as revenue and deposit repayments as an expense.

(b) If different models are used for different classes of insurance contract, the Board would need to define when each model is used. The definitions could target those contracts that are most likely to contain significant deposit components. However, we

have so far identified no other reason to draw boundaries between different classes of insurance contracts. The boundaries might be arbitrary and difficult to define.

(c) Permitting insurers to choose between a revenue presentation and a deposit presentation may allow them to select the most appropriate presentation in each case, but could undermine comparability.

(d) Unbundling all or specified contracts into an insurance component and a deposit component avoids the disadvantages of a single on-off switch that creates a radical presentation difference in the presentation of income and expense. However, unbundling could be arbitrary and costly to perform. To minimise these disadvantages, unbundling could be targeted at contracts for which the benefits are most likely to exceed the costs. The FASB plans to issue an Invitation to Comment on unbundling (bifurcation) in its project on insurance risk transfer (see agenda paper 4E). Responses can be expected to provide information on benefits and costs of unbundling.

(e) Presenting all premiums for all insurance contracts as deposit receipts would avoid the disadvantages of using an on-off switch to distinguish different types of contract. It would also avoid the costs of unbundling and avoid the need to determine how much of the original premium is earned (see paragraphs 13-17 for further discussion). However, it would be a significant change from current practice. It would also make it harder for users of non-life insurers' financial statements to derive commonly used ratios such as the claims ratio (claims expense divided by earned premium), expense ratio (expenses divided by earned premium) and combined ratio ([claims expense plus expenses] divided by earned premium).

Does it matter?

7. Does it matter whether premiums are treated as revenue or deposits? The staff believes it does. Many insurers like to report total premium revenue as a headline indicator of the size of the business. Because they regards such indicators as helpful to users, some insurers, particularly life insurers, use adjusted measures of premium revenue to give what is, in their view, a more comprehensive measure of their size. For example:

(a) Some life insurers report a performance metric they call 'annual premium equivalent'. This is the premium revenue for the year from recurring premium contracts plus 10% of the premium from single premium contract. The objective is to provide greater

comparability between insurers with different ratios of single premium business to recurring premium business.

(b) Some life insurers report performance metrics that combine premium revenue with non-revenue inflows for products such as mutual funds, long-term savings products and universal life contracts.

8. A cash flow statement prepared using the direct method might provide useful information, on a consistent basis, about inflows for savings-oriented products, regardless of whether they are insurance contracts, long-term savings contracts within the scope of IAS 39 or mutual funds.

9. In addition, some alleged abuses appear to have involved insurance or reinsurance accounting to account for significant deposit components, which resulted in allegedly misleading changes in performance metrics such as liabilities/premiums or combined ratios.

10. In summary, some insurers have devoted efforts to developing (and, allegedly, in some cases embellishing) performance metrics that are affected by reported revenue and expense. This suggests that insurers, and probably also users, view reported revenue and expense as important, and that it does matter whether premiums are treated as revenue or deposits.

Illustrations

11. To illustrate different presentations, the appendix to this paper shows how four different models could be applied:

(a) Typical **non-life insurance model**: Premiums received are recognised as a liability (unearned premium) and are then transferred to revenue as they are deemed to be earned.

(b) Typical **traditional life insurance model**: Premiums received are recognised immediately as revenue, and at the same time an addition to the liability is recognised as an expense.

(c) **Unbundled model**: Premiums received are recognised as a deposit receipt. Subsequently, amounts charged against a policyholder account balance for the provision of services are recognised as revenue. (If those charges are made in advance, they might be treated initially as unearned premium.) This approach is used

mainly for universal life contracts, and perhaps also for some reinsurance contracts with significant deposit components.

(d) **Margin model**: Premiums received are recognised as a deposit receipt. Subsequently, as the insurer is released from risk (and, if applicable, provides other services), the related portion of the risk margin amounts (and, if applicable, profit margin) is no longer needed and is recognised as revenue. A similar approach is often used by insurers to provide information about changes in embedded value (which is, in most cases reported outside the financial statements).

12. If the liability measurements are the same, these different approaches would have the same net effect on profit or loss, but the individual line items would differ.

Other comments

Non-linear patterns of risk

13. If part of all of the premium is treated as revenue, it is necessary to determine when the revenue should be viewed as earned. For many insurance contracts, that may reasonably be assumed to be on a straight-line basis, adjusted if the coverage varies seasonally (for example, insurance relating to winter sports). However, in some cases, it may be difficult to determine when premiums are earned, for instance if:

(a) the risk cannot be expressed easily as a simple linear factor (eg for some stop-loss contracts). For example, suppose a stop-loss contract covers 90% of aggregate losses during 2006 that exceed CU 10 million, up to a maximum payment of CU 9 million (ie 90% of aggregate losses in the layer between CU 10 million and CU 20 million). The premium is, say, CU 1.2 million. If aggregate losses at 30 June are CU 5 million, how much of the premium is now earned?

(b) the risk fluctuates both up and down over time (eg for some types of guarantee). Suppose an equity-linked life insurance contract provides a death benefit equal to the higher of (i) the account value and (ii) 100% of the amount invested. The insurer charges an explicit or implicit additional premium of CU 1,000. How much of the premium is earned if the account value stands at (A) 130% of the amount invested? (B) 100% of the amount invested? (C) 70% of the amount invested? (D) What if the account value goes down to 70% of the amount invested and then goes back up to 100%?

(c) claims have long tails. For example, suppose a non-life insurer sells annual contracts, subject to large long-tail claims, some of which are not resolved for ten years. Should the insurer recognise the whole premium as revenue over the one year term of the contract (the traditional treatment)? Or should some of the premium be recognised in later years when the insurer is still bearing risk (which seems more consistent with the notion that an entity should recognise revenue from providing services when it provides the services)?

14. If all premium revenue is treated as a deposit, it is not necessary to determine when each portion of the original premium from the policyholder is earned.

Earned and unearned

15. One perhaps minor difference between the traditional non-life and traditional life presentation models relates to unearned premium. The non-life presentation recognises the premium received initially as a liability, and subsequently recognises it as revenue over time as it is earned. Conventionally, the unearned portion is viewed as deferred revenue, thought we might view it as a cost-based measure of the stand-ready obligation.

16. In contrast, the traditional life model recognises premium receipts as revenue immediately when they are due, rather than later when they are earned. At the same time, the insurer recognises as an expense the resulting change in the liability. The net effect on profit is the same as in the non-life presentation, but the line items differ.

17. Why does this difference in presentation exist? One possible explanation is as follows: for a traditional one year non-life contract, the deposit component is relatively small and it is reasonable to view most of the premium as a prepayment for a service. For long-duration life insurance contracts, the deposit component may be much more significant and it is likely to be more difficult to distinguish the portion of the premium that is a prepayment for future services from the portion that is, in substance, a deposit.

Input from the Insurance Working Group

18. We have discussed aspects of income statement presentation with the Insurance Working Group several times. Participants have expressed the following views:

(a) The unbundled model used in US GAAP for universal life contracts provides an insightful insight into margins, but is difficult to apply to contracts that do not have explicitly unbundled charges.

(b) Summary numbers indicating the size of the business are important. At present, quite similar items are presented differently (eg bank deposits, insurance premiums, funds under management). This diversity does not help.

(c) Combined ratios and similar ratios are important performance indicators for non-life contracts.

(d) Although it may be difficult to define water-tight boundaries between different types of insurance contracts, it may not be important to have a single income statement presentation for all types of insurance contract.

Staff recommendation

19. In principle, premiums relating to the deposit component of an insurance contract should be treated as deposit receipts, not as revenue, and related repayments should be treated as deposit repayments, not as expenses. The cleanest ways to achieve this are:

    (a) to treat all premiums for all insurance contracts as deposits, or

    (b) to unbundle all insurance contracts

20. The staff recommends that the Board wait until after the Discussion Paper stage before choosing between these alternatives. At that time, the Board will have the benefit of responses to the IASB Discussion Paper on insurance contracts and to the FASB Invitation to Comment on insurance risk transfer.

21. Users rely heavily on combined ratios and related ratios to assess an insurer's performance with non-life insurance contracts. Furthermore, for these contracts, except for longer-duration non-life contracts or cases of abuse, deposit components are typically less significant. On the other hand, reported instances of alleged abuse appear to have been more common in non-life, so deposit components may be more important if they have been inserted deliberately, rather than being a natural by-product of the insurance component.

22. On balance, the staff recommends the following: For shorter duration non-life contracts with a coverage period of no more than about one year, an insurer should recognise all premiums as revenue when earned, after unbundling any deposit component that is not closely related to the underlying insurance exposure. The staff will consider possible criteria for such unbundling when the FASB receives responses to its forthcoming invitation to comment on risk transfer.

Appendix: Illustrations

The following example is designed to illustrate the four presentation approaches discussed in paragraph 11. The focus is on the style of presentation and so the example has been kept as simple as possible. To make comparison easier, the same example is used for all four presentations. The example has the following features:

- Premium CU 1,000, covering insured events between 1 January and 31 December.
- Expected claims CU 700. CU 350 is paid on 30 June and CU 350 on 31 december.
- Acquisition costs CU 100, incurred on 1 January
- Other expenses associated with the administration of the contracts CU 80, incurred evenly through the period.
- Expected investment return 8% and risk free rate used to discount the liability cash flows 5%.
- The insurer estimates that there is no material gain or loss at inception (1 January). On 30 June, the insurer estimates that the appropriate margin is CU 69, which results in a liability measurement of CU 450 (coincidentally equal to a conventional unearned premium of CU 500 less conventional deferred acquisition costs of CU 50).
- No differences between actual outcomes and previous estimates.
- This illustration focuses on the presentation of premiums for a contract that does not include an explicit deposit component.

Traditional non-life income statement

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Premiums written	1,000		
Change in unearned premium	(1,000)	500	500
Premiums earned	0	500	500
Investment income		36	22
Claims		350	350
Expenses		40	40
Acquisition costs		50	50
Total expenses	0	440	440
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	
Equity	0	96	178
Claims ratio		70%	70%
Expense ratio		8%	8%
Combined ratio		78%	78%

Comments:

1. Premiums written are the premiums that became payable during the period (almost a cash basis). Premiums earned are the premiums written, less the portion considered unearned). Many non-life insurers use this two-stage presentation of premiums.

2. The line for acquisition costs shown here relates to amortisation of acquisition costs of CU 100 incurred at inception. This style of presentation is not fully consistent with the measurement model, because acquisition costs are not deferred. An alternative presentation would show acquisition costs of CU 100 as an expense at inception, earned premium revenue of CU 100 at inception and earned premium revenue of CU 450 (instead of CU 500) in each six month period. However, some may feel that none of the premium revenue is really 'earned' at inception.

Traditional life income statement

	Inception	*six months to 30 Jun*	*six months to 31 Dec*
	1 Jan		
Premium revenue	1,000		
Investment income		36	22
Total income	1,000	36	22
Claims		350	350
Change in insurance liability	900	(450)	(450)
Expenses		40	40
Acquisition costs	100		
Total expenses	1,000	(60)	(60)
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	
Equity	0	96	178

Comments:

1. The line ‘change in insurance liability’ does not seem particularly helpful because it shows the result of a computation, not the effect of a real economic event.

2. This presentation does not require the insurer to analyse the reasons for changes in the liability. Such analysis may be complex for traditional products that bundle together many elements.

Unbundled presentation

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Charges to policyholder account	-	473	461
Policyholder benefits	-	(350)	(350)
Expenses	-	(40	(40)
Insurance margin		83	71
Gain at inception	100		
Acquisition costs	(100)		
Net gain at inception	0	0	0
Investment income		36	22
Interest on insurance liability		(23)	(11)
Net interest and investment	0	14	11
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	-
Equity	0	96	178

Comments:

1. This format:

   (a) treats all premiums as deposits (except the portion needed to pay for acquisition costs).

   (b) subsequently presents as revenue the explicit or implicit charges made to policyholder accounts.

2. In US GAAP, a somewhat similar presentation is used for universal life contracts. This format is possible for these contracts because the design of the contract unbundles the different contract elements. This approach may be more challenging if charges to policyholders are implicitly bundled into a premium, rather than identified explicitly.

3. In this illustration, there is no explicit policyholder account and, hence, no explicit charge. The amounts shown as policyholder charges are implicit and are computed as the expected value of policyholder benefits and expenses, plus the risk margin (and, if

applicable, profit margin) released in the period. (The margin presentation that follows next shows as revenue only the release of those margins.)

Margin presentation

	Inception 1 Jan	*six months to 30 Jun*	*six months to 31 Dec*
Insurance margin		83	71
Gain at inception	100		
Acquisition costs	(100)		
Net gain at inception	0	0	0
Investment income		36	22
Interest on insurance liability		(23)	(11)
Net interest and investment	0	14	11
Profit	0	96	82

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	-
Equity	0	96	178

Comments:

1. This format is similar to the analysis of movements in embedded value provided by many larger life insurers in the UK, Continental Europe, Australia, 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. 'Release of margins' refers to the difference between the margin at the start of the period and the margin at the end of the period. It reports the estimated margin that market participants would have required at the start of the period for bearing risk during the period.