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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting: **Insurance Working Group, April 2008**
Paper: **Risk margins – interaction between balance sheet and performance statement (Agenda paper 7A)**

Purpose of this paper

1. The main purpose of this paper is to demonstrate the interaction between margins in the balance sheet and release of margins in the performance statement.

Basic principle of risk margins

2. Under the proposals in the discussion paper:

   (a) the measurement of an insurance liability includes a risk margin.

   (b) when the insurer is released from risk in subsequent periods, the risk margin reduces, and the insurer recognises the release from risk in profit and loss as income.

3. Respondents generally agreed with this basis principle. (Respondents had many concerns about various aspects of the principle, but those concerns are beyond the scope of this paper.)

4. Example 1 illustrates the basic principle. To focus on that principle, example 1 is a basic example with many significant simplifications, for example:

(a) no acquisition costs

(b) no differences between entity-specific estimates and estimates of market participants

(c) no profit at inception

(d) no subsequent change in estimated cash flows

(e) no separate ‘other services’ provided, so no need to consider whether a service margin is required

(f) claims are settled by the end of the insurance coverage period.

(g) for simplicity, the example is a one year contract. However, the issues illustrated in this paper would be identical for longer term contracts, both life and non-life.

5. Example 1 uses a prospective model based on future cash flows, with an explicit risk margin and discounting. The face of the performance statement recognises the release of the risk margin as revenue.

Risk margins under IAS 18

6. Several respondents commented on the inconsistency between the model proposed in the discussion paper and general approaches to revenue recognition, such as that used in IAS 18 *Revenue* and the customer consideration approach, as currently discussed in the Revenue Recognition Project. Example 2 illustrates how the basic principle of the risk margin is also present, implicitly, in IAS 18.

7. The basic data are in line with Example 1, however:

(a) The contract is regarded as rendering of services, where, arguably, the service is providing insurance coverage. Therefore, revenue is recognised on the basis of risk coverage provided in the period. (With this example staff does not wish to imply that insurance contracts or components of insurance contracts should, or should not, be regarded as service contracts.)

(b) As determined by IAS 18, no discounting is applied.

8. The example demonstrates that IAS 18 also includes implicit margins at inception which are (implicitly) released to profit and loss as services are provided. The same would also apply under the customer consideration approach. Indeed, the inclusion at inception of implicit or explicit risk margins is a feature of all insurance accounting models of which the staff is aware, including also embedded value approaches.

9. Example 2 shows premiums as revenue (when earned) and claims as an expense (when incurred) since this presentation is more consistent with IAS 18 than the margin presentation used in example 1.

Case with extended claims settlement period

10. In examples 1 and 2 the claims are settled by the end of the coverage period. Example 3 and 4 are the same as examples 1 and 2, but with claims being paid out 6 months after the end of coverage period.

11. Example 3 shows that for a prospective approach the release of the risk margin occurs throughout both the coverage period and the claims settlement period. The drivers of the risk margin (and of the release from risk) are:

    (a) frequency of claims (the example assumes the release of this risk takes place entirely over the coverage period)

    (b) severity of claims. For simplicity, the example assumes there is no release of the margin for severity risk until actual settlement.

12. Example 4 shows one view of how IAS 18 might apply for a non-life insurance contract, if such a contract were within the scope of IAS 18. In this example, revenue is recognised on the basis of risk coverage provided in the period. No revenue is recognised during the claims settlement period.

Questions for participants

13. **Do you have any comments on the interaction between (a) risk margins and (b) the subsequent release of those risk margins?**