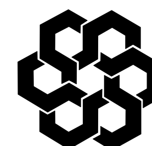

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International Accounting Standards Board

This document is provided as a convenience to observers at Insurance Working Group meetings, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
Note: These notes are based on the staff paper prepared for the Insurance Working Group Meeting. Paragraph numbers correspond to paragraph numbers used in the Insurance Working group paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting: **Insurance Working Group, April 2008**
Paper: **Day one profit (Agenda paper 7D)**

Purpose of this paper

1. This paper considers what happens when the initial measurement of an insurance liability results in a net profit at inception. For convenience, this paper describes such a profit as **day one profit**.

2. In this paper:

   (a) '**gross** day one profit' refers to day one profit before acquisition costs

   (b) '**net** day one profit' refers to day one profit after acquisition costs.

   (c) 'inception' refers to the date when the insurer and policyholder enter into the contract, rather than the date when the coverage period begins (if different). This paper also assumes that the insurer receives the first premium at inception. The paper does not consider whether there are any accounting implications of differences between the date of inception and the date when the insurer receives the first premium.

3. This paper begins by reviewing what the comment letters said about day one profit. It then discusses three questions:

(a) Can a significant day one profit arise at the inception of an insurance contract? (paragraphs 5-11)

(b) If a significant profit does arise at inception, how should an insurer account for that profit? (paragraphs 12-22)

(c) What implications do acquisition costs have for the treatment of day one profits? (paragraphs 23-25)

Summary of comment letters

4. The following is a high level summary of what responses to the discussion paper said about day one profit:

   (a) Respondents were divided (as was the Board) on whether it would be acceptable to recognise a net day one profit.

   (b) The discussion paper took the position that net day one profits would be rare, except perhaps in some niche markets. However, some respondents believed that net day one profits would be common and significant.

   (c) Some suggested that any net day one profit should not be recognised immediately in profit or loss, but should instead be recognised separately (either as a separate liability or through other comprehensive income) and subsequently recognised in profit or loss in line with the release from risk or as other services are provided. In some suggestions, the insurer would also recalibrate those amounts in specified circumstances when estimated cash flows change subsequently (such recalibration would reduce the net effect on profit or loss at the time of the change in estimated cash flows).

   (d) In general, opposition to immediate recognition of net day one profits in profit or loss came from respondents who believed net day one profits would be significant. Support for immediate recognition in profit or loss came from those who believed net day one profits would not normally be significant, except in niche markets and similar cases.

(e) Many respondents asked the Board to clarify how the approach to revenue recognition in this project relates to the approach in IAS 18 *Revenue* and the two approaches the Board is considering in the revenue recognition project (a measurement approach and a customer consideration approach).

Can a significant day one profit arise?

5. The discussion paper took the position that net day one profits would be rare, except in special cases (for example, if the insurer is in a niche market protected by barriers to entry or if the insurer has superior distribution systems). Arguments for this position are as follows:

   (a) Insurance contracts arise from a transaction in competitive markets between informed, willing, independent parties. Accordingly, both parties believe the transaction price is fair.

   (b) A net day one profit for the insurer implies that the policyholder has overpaid and should recognise a loss at inception.

6. Several respondents suggested that significant profits can arise at inception, even in competitive markets for transactions between informed, willing, independent parties. Arguments for this position are as follows:

   (a) In pricing insurance contracts, insurers seek to recover not only the cost of providing the insurance coverage (present value of expected cash flows plus margins), but also the cost of acquiring policyholders and originating the contracts. From the policyholder's perspective, the latter costs are an unavoidable part of the cost of acquiring the insurance coverage. However, from the insurer's perspective, the latter costs do not relate to its remaining obligation to provide insurance coverage.

   (b) The costs of acquiring contracts and originating contracts include acquisition costs incurred in the current period (eg agents' commission and sales force salaries). They also include costs incurred in previous periods in developing branding, distribution systems and product development. Insurers price to recover those costs, as well as a reasonable return on them. These costs are often very significant. Therefore, it is

reasonable to assume that significant net day one profits could arise. Those profits could be viewed as an implicit fee for the effort of assembling a portfolio of contracts.

(c) Pricing in some insurance markets is cyclical. At some points in the cycle, losses can be expected at inception. At other points, profits can be expected at inception.

(d) Different insurers sometimes charge different premiums for the same coverage. This suggests that insurers sometimes issue contracts at a loss and sometimes issue contracts at a profit.

7. Day one profit could also arise from an element captured in pricing but not reflected in accounting measurements or vice versa. (An example of such a difference is if the pricing reflects policyholder participation, but accounting requirements specify that the measurement of the insurance liabilities must exclude policyholder participation that does not arise from a legal or constructive obligation.) This paper does not explore this question further.

8. It is difficult to discuss day one profit in full without specifying every detail of the measurement model that will be used. For the high level discussion in this paper, we have assumed that the measurement attempts to portray some sort of economic value of the contract from the insurer's perspective. This paper does not try to specify exactly what that involves.

9. The following example illustrates the relevant notions.

Example

Insurer A intends to offer an insurance contract to potential policyholders. A estimates that the expected present value of cash outflows (ie policyholder benefits) will be CU90 and that an appropriate margin for bearing risk and providing other services is CU10. A also expects to incur acquisition costs of CU5. A decides that it requires CU7 as a contribution towards recovery of costs that it incurred in the past in developing the branding, distribution and product development needed to put it in a position to put this product on the market. The contribution of CU7 also includes a contribution towards a reasonable return on those costs. Thus, A requires a premium of CU112 for this contract (CU90 + CU10 + CU5 + CU7).

From the policyholders' perspective, it is buying coverage worth (at least) CU112.

From insurer A's perspective, its remaining obligation is to provide coverage that it views as having a value of CU100 (expected present value of cash flows of CU90 plus margin of CU10). A gross day one profit of CU12 arises at inception. CU5 of this pays for acquisition costs, leaving a net day one profit of CU7. Depending on the approach adopted for day one profits, that amount of CU7 would be:

- recognised immediately at inception.
- recognised initially as a liability (part of the insurance liability or a separate liability), and subsequently recognised in profit or loss over the life of the contract.
- recognised initially in other comprehensive income (OCI), and subsequently recycled to profit or loss over the life of the contract.

Retail margins and wholesale margins

10. Some think of day one profit as arising from a difference between retail margins and wholesale margins. Agenda paper 7C discusses whether there is a distinction between retail margins and wholesale margins. It argues that, in principle:

    (a) there is no distinction between retail **risk** margins and wholesale **risk** margins.

    (b) there could be a distinction between retail **service** margins and wholesale **service** margins. However, that difference does not give rise to a day one profit if the measurement of an obligation to provide services includes service margins. Agenda paper 7E discusses service margins.

    (c) if an insurer prices a contract to provide a reasonable return on the effort of finding and adding retail policyholders (an implicit portfolio assembly fee), that return would result in a day one profit.

A misplaced concern

11. Some have expressed a concern that net day one profit equals the entire profit expected over the life of the contract. However, that is not the case for any approach that has ever been discussed by the Board, the Insurance Working Group or the former IASC Steering

Committee. Even if an insurer recognises some day one profit, it would recognise the following items as income or expense in later periods:

(a) release from risk during the period (ie the difference between the opening and closing risk margins) and, if applicable, compensation for providing services during the period (ie the difference between the opening and closing service margins).

(b) investment margin (ie return on assets held, less interest accumulated on the insurance liability).

(c) experience adjustments (ie differences between the actual cash flows and their previous expected value) and changes in estimates.

If a significant profit does arise at inception, how should an insurer account for it?

12. Respondents suggested various approaches for day one profits:

(a) immediate recognition in profit or loss (paragraph 13)

(b) inclusion in the initial measurement of the insurance liability, with subsequent release to profit or loss over the life of the contract (paragraphs 14 and 15)

(c) recognition as a separate liability, distinct from the insurance liability, with subsequent release to profit or loss over the life of the contract (paragraphs 16 and 17). Some respondents use terms such as 'profit margin' or calibration margin' to describe net day one profit that is recognised as a separate liability.

(d) recognition at inception in other comprehensive income (OCI), with subsequent transfer to profit or loss ('recycling') over the life of the contract (paragraphs 18 and 9)

(e) rebuttable presumption of no day one profit (paragraphs 20)

Immediate recognition in profit or loss

13. Some respondents support immediate recognition in profit or loss of any day one profit, on the following grounds:

(a) An IFRS on insurance contracts should not restrict the recognition of day one profits if all assets and liabilities relating to the contract are recognised and measured appropriately. Prohibiting the recognition of day one profits would lead to the inclusion in liabilities of deferred profits that do not meet the Framework's definition of a liability because they do not represent obligations. The result would not be a faithful representation of the insurer's financial position.

(b) If net day one profits occur, they arise from the insurer's sales effort. The logical time to recognise them is when that effort occurs.

(c) Most people agree that an insurer should recognise a loss at inception (using a liability adequacy test) if it has underpriced a contract. This raises several issues:

(i) Consistency and neutrality suggest that the same principle should apply to day one profits.

(ii) It would be necessary to decide whether the liability adequacy test should refer to cash flows only (suggested by some respondents) or to cash flows plus a margin (suggested by other respondents). This paper does not examine this question, and does not deal with other aspects of losses at inception.

(iii) If the liability adequacy test refers to cash flows plus a margin, an insurer would need to estimate the margin. A rough estimate might suffice if the actual premium is clearly adequate. However, the need to carry out this test would create an additional burden and would reduce the benefit of attempting to calibrate to the price observed for the transaction with the policyholder.

(iv) The frequency and size of losses identified will depend on the level of aggregation used for the liability adequacy test, because aggregation implicitly offsets losses on some contracts against gains on others.

(v) It would be necessary to define relevant acquisition costs for the initial calibration of the margin.

(vi) Criteria would be needed to distinguish amendments to an existing contract from the cancellation of an old contract that is replaced by a new contract.

(d) An insurer sometimes charges different premiums for identical obligations, for example because it wishes to balance its portfolio by encouraging some risk profiles and discouraging others. If this occurs and the initial measurement is calibrated to avoid reporting day one profits, two identical obligations could be measured at different amounts.

(e) If an insurer added value by issuing a contract, the financial statements should report that added value. That added value could be regarded as an implicit fee for assembling a portfolio. Reporting that added value as income could respond to the wish of some users for information about the level of new business, and its estimated profitability. Disclosures about new business often interest users of the embedded value information that some life insurers produce.

(f) Although subsequent losses, lapses or other events could reverse profits that were appropriately recognised at inception, it is more transparent to report those events when they occur, rather than to obscure them by offsetting them against profits that were deferred at inception.

(g) As noted in paragraph 6(c) above, pricing in some insurance markets is cyclical. It would be inconsistent to recognise day one losses in a soft market without recognising day one profits when the market is hard.

Inclusion in the initial measurement of the insurance liability

14. Some support including any day one profit in the initial measurement of the insurance liability. They would subsequently recognise that profit in profit or loss over the life of the contract, probably using a pattern that reflects the release from risk. They offer the following arguments against immediate recognition in profit or loss:

(a) Immediate recognition in profit or loss would be inconsistent with the general principles for revenue recognition in IAS 18 *Revenue*. It would also be inconsistent with the customer consideration approach, which is one of the two apporaches the Board is considering in the project on revenue recognition. Under IAS 18 and the customer consideration approach, an entity would recognise no revenue until it begins to discharge its obligation to provide the services specified by the contract.

(b) Investment fund managers apply IAS 18 to their investment management contracts, and thus do not recognise day one profits. Many life insurance contracts contain components that are close substitutes for products based on mutual funds. These similar products should be subject to similar accounting.

(c) Immediate recognition will lead to volatility in profit or loss.

(d) Immediate recognition may result in the recognition of profits that may not ultimately be received in cash if experience is worse than the insurer estimates at inception.

(e) It would be unhelpful to users to report a net day one profit based on an inherently subjective and imprecise estimate when, in many cases, a wide range of reasonable estimates is possible.

(f) The transaction with the policyholder provides the only observable direct market benchmark for the margin. For a margin determined on another basis, it is not possible to establish whether a day one profit is genuine, rather than the result of a measurement error. Moreover, the required margins cannot be 'back-tested'. In other words, the actual cash flows from a book of contracts can never validate the earlier estimate of the margin. This is because the margins reflect both the quantity of risk and the price per unit of risk. Actual outcomes over some years might give some level of confidence that the quantity of risk has been estimated reliably, but later events can never show whether the price per unit of risk was appropriate.

(g) Recognising net day one profits is inconsistent with IAS 39 *Financial Instruments: Recognition and Measurement*. IAS 39 prohibits the recognition of gains at inception if they are not evidenced by comparison with other observable current market transactions or not based on a valuation technique whose variables include only data from observable markets.[1] Measurements of insurance contracts would always rely largely on data that are not from observable markets.

(h) Recognition of a net day one profit is imprudent, especially if based on inherently subjective estimates. Information about the value added by new contracts is useful supplementary disclosure, especially for long-term contracts, and complements the

measurements in the financial statements, but is unsuitable for inclusion in those measurements.

(i) Recognising a profit at the inception of non-life contracts may make it more difficult for users to interpret traditional ratios, such as the claims ratio and the combined ratio.

15. Opponents of this approach provide the following arguments:

(a) The day one profit does not meet the Framework's definition of a liability.

(b) If day one profits occur, they arise from the insurer's sales effort. The logical time to recognise them is when that effort occurs. Recognising them at any later time would be arbitrary.

Recognition as a separate liability

16. Some support recognising any net day one profit as a liability separate from the insurance liability. They would subsequently recognise that profit in profit or loss over the life of the contract. They offer the following arguments for this approach:

(a) For the reasons given by those who support inclusion in the initial measurement of the insurance liability, any day one profit should not be recognised immediately in profit or loss.

(b) If the day one profit is included in the measurement of the insurance liability, it will obscure the reporting of the 'true' insurance liability.

17. Those who oppose this approach offer the same arguments as those they offer against inclusion in the measurement of the insurance liability.

Recognition at inception in other comprehensive income, with subsequent 'recycling'

18. Some respondents recommend that profits arising at inception should be recognised at inception in other comprehensive income (OCI), with subsequent transfer to profit or loss ('recycling') over the life of the contract. They recommend this because they believe that profits arising at inception:

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[1] IAS 39 Appendix A, paragraphs AG71 and AG76 and *Basis for Conclusions on IAS 39*, paragraph BC98.

(a) should not be recognised as a liability. In their view, day one profit does not represent a liability.

(b) should not be recognised at inception in profit or loss. They believe this for reasons similar to those given by those who would treat any day one profit as part of the insurance liability or as a separate liability.

19. The following are arguments against this approach:

(a) Existing uses of OCI relate to remeasurement of existing assets and liabilities, for example changes in the fair value of available-for-sale securities. There is no precedent in IFRSs for using OCI to report the result of recognising an asset or liability for the first time. Moreover, the Framework and IAS 1 *Presentation of Financial Statements* provide no basis for extending the use of OCI in this way.

(b) If profits arise at inception, they arise from the insurer's sales effort. The logical time to recognise them is when that effort occurs.

Rebuttable presumption

20. For many insurance contracts, estimates of future cash flows and margins are inherently subjective and imprecise. Thus, a wide range of reasonable estimates is possible. Therefore, some suggest that there should be a rebuttable presumption that no profit arose at inception. So long as the initial measurement implied by the premium (ie the amount that produces no net day one profit) falls within the range of reasonable estimates, the insurer would recognise no net day one profit. On the other hand, if the amount implied by the premium falls outside a reasonable range, the insurer would recognise a profit (or loss).

Basis for subsequent release of day one profits

21. As discussed above, some suggested that any net day one profit should be recognised initially as a liability or in OCI, not in profit or loss. These respondents suggested that the profit should subsequently be recognised in profit or loss over the life of the contract. Most advocates of these approaches suggested that the profit should be recognised in profit or loss in proportion to the relief from risk. In effect, this would be a grossing up of

the 'true' release from risk, because the risk margin is already intended to reflect the full economic effect of risk.

22. Some respondents suggested a variation on this approach for cases where subsequent changes in non-financial estimates make the contract less profitable than the insurer had originally estimated. They suggested that the day one profit should then be recalibrated. That recalibration would, in effect, absorb adverse changes in non-financial estimates. In consequence, there would be no net effect on profit for the period until the day one profit is completely exhausted.

Acquisition costs

23. One argument put forward by those who oppose recognition in profit or loss of any day one profit is the inconsistency with the existing approach to revenue recognition under IAS 18. As they note, it is also inconsistent with the customer consideration approach that the Board and the FASB are considering in their joint project on revenue recognition IAS 18 and the customer consideration approach focus on the recognition of top-line revenue, not profit for the period. Thus, if the Board adopts one of those approaches, we need to consider how this would affect the treatment of acquisition costs. At inception, the insurer has not yet provided a service to the policyholder. Therefore, IAS 18 and the customer consideration approach would not permit an insurer to recognise any revenue at inception, even though part of the premium pays for acquisition costs. If the Board maintains this principle, there are two alternatives to consider:

    (a) Recognise acquisition costs as an expense when incurred. In many cases, this will result in a net day one loss.

    (b) Defer acquisition costs, and amortise them over the life of the contract as the insurer recognises the related revenue. Some object to this, for the following reasons:

        (i) Some argue that deferred acquisition costs are a pseudo-asset that does not meet the definition of an asset.

        (ii) Others argue that deferred acquisition costs are the cost of something that meets the definition of an asset, namely a customer relationship. However, some dispute whether the amount of deferred acquisition costs is a meaningful measurement of

the cost of the asset that it purports to represent, namely a customer relationship. They also question whether subsequent amortisation of that amount results in meaningful information.

24. Respondents to the discussion paper generally agreed that acquisition costs should be recognised as an expense when incurred, if the measurement reflects all future cash flows from which acquisition costs would be expected to be recovered.

25. Some respondents favoured an unearned premium approach for the pre-claims period of non-life insurance contracts. Some of those respondents preferred to recognise acquisition costs as (the cost of) an intangible asset, to be amortised in line with the recognition of premium revenue.

Questions for participants

26. **Can a significant profit arise at the inception of an insurance contract? If so, how should an insurer account for that profit:**

    (a) **immediate recognition in profit or loss?**

    (b) **inclusion in the initial measurement of the insurance liability, with subsequent release to profit or loss over the life of the contract?**

    (c) **recognition as a separate liability, distinct from the insurance liability, with subsequent release to profit or loss over the life of the contract?**

    (d) **recognition at inception in other comprehensive income (OCI), with subsequent transfer to profit or loss ('recycling') over the life of the contract?**

    (e) **rebuttable presumption of no day one profit**

    (f) **Other? (please specify)**

27. **How should an insurer treat the portion of the premium that pays for acquisition costs?**

(a) **When the insurer incurs the acquisition costs, recognise that portion of the premium as income and at the same time recognise the acquisition costs as an expense.**

(b) **Recognise the acquisition costs as an expense when incurred, but recognise the related portion of the premium as income over the life of the contract (please specify the basis).**

(c) **Defer the acquisition costs and amortise them over the life of the contract, and recognise the related portion of the premium as income as the deferred costs are amortised.**

(d) **Other (please specify)**