Project **Insurance Contracts**

Topic **Presentation of the performance statement**

Purpose of this paper

1. This paper discusses presentation of the performance statement (the statement of comprehensive income).The paper describes the models we identified for presenting the performance statement. To illustrate these models, the appendix to this paper includes examples of the models. These examples also illustrate, at a high level, how an insurer could disaggregate changes in insurance liabilities in the performance statement, including presentation of subsequent remeasurements.

2. The paper also addresses the following questions:

   (a) when (if ever) should an insurer recognise premium receipts as revenue?

   (b) when (if ever) should an insurer recognise them as deposit receipts?

Summary of staff recommendations

3. This paper argues that an insurer should

   (a) base revenue on an earned basis, rather than on a written basis

   (b) not report as revenue the part of the premium that does not relate closely to the insurance coverage and other services (if any) provided under the contract (ie the insurer should not report as revenue the premium that relates to expected future repayments to the same policyholders).

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Structure of the paper

4. The rest of this paper is divided into the following sections:

   (a) Presentation models (paragraphs 6-10)

   (b) When is revenue recognised? (paragraphs 11-13)

   (c) Should the whole premium be reported as revenue? (paragraphs 14-17)

   (d) Which models are still under consideration? (paragraphs 18-19)

   (e) Margin presentation models (paragraphs 20-28)

   (f) Application of the presentation models (paragraphs 29-32).

5. It is beyond the purpose of this paper to discuss the following:

   (a) every detail of a disaggregation of changes in insurance liabilities in the performance statement. We will discuss the details on disaggregation in a follow-up meeting once the boards have selected the basic structure of the performance statement.

   (b) whether an insurer should recognise some or all changes in insurance liabilities in other comprehensive income (OCI) rather than in profit or loss. Agenda paper 16 discusses that topic.

   (c) whether recognition of revenue should be limited to the period during which protection is provided or whether revenue should also be recognised during the claims handling period. We will address this during a future meeting.

   (d) whether an insurer should unbundle insurance contracts. Agenda paper 7D (FASB memorandum 32D) discusses that topic.

Presentation models

6. In their October joint meeting, the boards discussed the following presentation models:

   (a) **Written premium.** Premiums received are recognised immediately as revenue (written premium) and at the same time a corresponding increase in the liability

is recognised as an expense (described in the October papers as the traditional life model).

(b) **Earned premium.** Premiums received are recognised as a liability (unearned premium) and are then transferred to revenue as they are deemed to be earned (described in the October papers as the traditional non-life model).

(c) **Unbundled (fee).** The elements of premiums that represent expected repayments to the same policyholder are recognised as a deposit receipt. Conversely, amounts charged to a policyholder for the provision of protection against risk (and, if applicable, other services) are recognised as revenue when the insurer performs under the contract by providing that protection. If those charges are made in advance, they would be treated initially as a prepayment for future services (similar to unearned premium). [We note that many insurance contracts do not have explicitly unbundled charges].

(d) **Summarised margin.** 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 margin amount is no longer needed and is recognised as revenue in the income statement. The margin model treats all premiums as deposits and all claims and benefits as repayments to the policyholder; those elements are treated as movements of the insurance liability.

(e) **Expanded margin.** Reports as revenue an amount equal to the margin released during the reporting period plus some or all of the insurance losses and expenses. This approach could be seen as a combination of a 'pure' margin model (d) and earned premium model (b) or a fee model (c).

7. We emphasise that, under the same liability measurement, these different approaches would have the same net effect on profit or loss, although the individual line items in the performance statement could differ significantly.

8. The discussion paper *Preliminary Views on Insurance Contracts* discussed whether premiums should be treated as revenue, as deposits, or as a mixture of revenue and deposits, but did not put forward specific proposals on this topic. Most respondents

viewed all premiums as revenue, especially for non-life contracts. However, some saw merit in a presentation that treats some or all premiums as deposit receipts, particularly for life contracts. Others proposed retaining a revenue presentation in the performance statement (premiums shown as revenue, claims shown as an expense), supplementing this with a margin analysis in the notes, especially for life contracts. In this context, some saw life contracts as closer to financial instruments and non-life contracts as closer to service contracts. [The results from the field testing questionnaire on presentation of the performance statement showed similar responses].

9. The presentation models are assessed based on two key questions:

   (a) when is revenue reported?

   (b) which part of the premiums is reported as revenue throughout the life of the contract?

10. The table below summarises each of the approaches.

Approach	**When is revenue reported?**	**Which part of the premium is reported as revenue?**
Written premium	On receipt, with amounts that relate to future periods added to insurance liabilities.	All elements of the premium.
Earned premium	As ‘earned’ through performance under the contract.	All elements of the premium.
Unbundled (fee)	As ‘earned’ through performance under the contract.	The part of the premium that the policyholder pays for services under the contract.
Summarised margin	As ‘earned’ through performance under the contract.	Only the part of the premium that is released as a margin over the life of a contract.

Expanded margin	As ‘earned’ through performance under the contract.	The part of the premium that is released as a margin over the life of a contract, plus some or all of the insurance losses and expenses.

When is revenue recognised?

11. If some or all premiums are reported as revenue, one has to decide when premiums should be reported as revenue. We identified two approaches:

    (a) at receipt, with amounts that relate to future periods added to insurance liabilities (written);

    (b) as ‘earned’ through performance under the contract (earned).

12. The first approach is simple because it reports revenue based on receipt (written basis) and is also used under many existing reporting models for life insurance. In some cases, for example a regular premium with level risk, written basis might be an approximation for earned basis. However, the pattern in which premiums are written may differ from how the insurer performs under the contract; in some cases those differences could be significant. The staff therefore concludes that this approach is inconsistent with existing practices for recognising revenue for contracts other than insurance contracts and with the boards’ proposed model in the project on revenue recognition.

13. For an approach based on earned amounts, the written premium related to future periods will be booked as a payment received in advance for future services and treated as unearned. Once deemed to be earned as a result of subsequent performance under the contract, it will be reported as revenue. This is consistent with the model proposed in the revenue recognition discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers*. Staff concludes that an insurer should recognise revenue based on an earned basis rather than written basis.

Question 1 for the boards

In paragraph 13, staff recommends that an insurer should base revenue on an earned basis rather than written basis.

Do you agree with the staff recommendation?

Should the whole premium be reported as revenue?

14. If the performance model recognises revenue, one also has to decide whether all or some premiums will be reported as revenue over the life of the contract.

15. Under the model proposed in the project on revenue recognition, an entity would report as revenue the part of the premium (if any) that is the consideration provided by the customer for services provided under the contract.

16. Some of the approaches analysed in this paper recognise more revenue than the consideration for services under the contract because they include in the revenue line the part of the premium that relates to expected future repayments to the same policyholders (ie the deposit component). Such an approach would therefore be inconsistent with the proposed revenue model. Moreover, because the deposit component is not linked to a service provided under the contract, the revenue line would in many cases not produce a pattern that provides a useful depiction of performance. [This analysis is consistent with the comments made by some respondents to the discussion paper *Preliminary Views on Insurance Contracts* that the existing income statement formats for life insurers are not meaningful.]

17. Staff therefore concludes that an insurer should report as revenue that part of the premium that reflects the consideration the insurer receives for services under the contract and the insurer should not report as revenue the part of the premium that does not relate closely to the insurance coverage and other services (if any) provided under the contract (ie the insurer should not report as revenue the premium that relates to expected future repayments to the same policyholders).

Question 2 for the boards

In paragraph 17, staff recommends that an insurer should not report as revenue the part of the premium that does not relate closely to the

insurance coverage and other services (if any) provided under the contract (ie the insurer should not report as revenue the premium that relates to expected future repayments to the same policyholders).

Do you agree with the staff recommendation?

Which models are still under consideration?

18. If the boards were to agree with the recommendation in the previous sections to recognise revenue based on an earned basis and not to recognise as revenue the deposit element of the premium, we would no longer consider:

    (a) a written premium model because it recognises as revenue:

        (i) the premium when written rather than when it is earned

        (ii) the part of the premium that, either implicitly or explicitly, is not linked to a service the insurer provides to the policyholder under the contract.

    (b) earned premium, if the deposit component is relatively significant and could not be seen as a prepayment for services provided under the contract in future periods. This would be the case for many longer term insurance contracts, particularly, but not exclusively, for life insurance.

19. Accordingly, the following models would still be under consideration:

    (a) If the insurer would not be required to unbundle the contract:

        (i) an earned premium model if the deposit component is relatively small. In that case it may be reasonable to view most of the premium as a prepayment for a service. This would apply to many non-life contracts (but perhaps not all), but would exclude many life contracts. Application of this model would fit in with an unearned premium approach for measuring the pre-claims

liability of short-duration contracts, as a simplified alternative to the measurement required in all other cases[1].

(ii) A margin model or expanded margin model, which would be applicable in all cases, including contracts with significant embedded derivatives and long-duration contracts with significant deposit components that are expected to be repaid to the same policyholder in future years; this would apply to many life contracts. Paragraphs 20-28 further discuss margin presentation models.

(b) If the insurer would be required to unbundle for recognition and measurement:

(i) an unbundled (fee) approach. In agenda paper 7D, staff argued that an unbundled presentation should be applied if, and only if, a contract is also unbundled for recognition and measurement; in that case the fee approach would be applied to the insurance component.

Margin presentation models

20. The previous sections showed that i) a model that reports earned premiums as revenue could only be used if the deposit component is relatively small and ii) an insurer may be required to unbundle the contract in some cases but not all. Consequently, those approaches would not be able to cover all types of contracts, particularly contracts with a significant deposit component and/or significant embedded derivatives. To deal with such contracts, we explore a presentation model based on the margin the insurer releases during the reporting period. We identified:

(a) a summarised margin approach and

(b) an expanded margin approach.

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[1] In its July 2009 meeting, the IASB decided to require (rather than permit) the use of an unearned premium approach for contracts that meet specified factors, defined broadly along the lines of pre-claims liabilities of short-duration insurance contracts. The FASB will discuss this topic at a future meeting.

21. The appendix to this paper includes examples of both margin approaches.

Summarised margin approach

22. A summarised margin approach:

(a) gives a simple and straight-forward presentation, in contrast to many existing presentations (particularly the presentations for life insurance contracts).

(b) fits in with the building block approach, in which the margin is identified as an explicit component.

(c) is already quite close to an analysis by profit driver; an insurer might even be able to show an high-level analysis by profit driver on the face of the performance statement, perhaps supplemented with more detail in the notes.

23. However, a summarised margin approach has the following disadvantages:

(a) it does not report as revenue all of the consideration paid by the policyholder for services under the contract. Rather, it reports as revenue a subset of that amount only, namely the released margin. As a result, it is inconsistent with the definition of revenue in IAS 18 *Revenue*, which defines revenue as gross-inflows from an entity's ordinary activities. Under existing US GAAP, revenue is also presented as gross inflows from the entity's activities (except in situations where an entity is acting as an agent of another party).

(b) it does not show a number of line items, for example expenses, that would normally, as part of the natural flow of the presented items, be shown on the face of the performance statement.

(c) because it shows the net margin in a collapsed way, it arguably cannot be reconciled to other presentation models. If, for example, an insurer used an unearned premium model for only part of its business, the insurer would show two income statement presentations; one for the unearned premium model and one for the margin model. The same would arguably be true if the insurer generates fees from asset management activities; the proceeds from those

activities are reported as ‘gross’ revenue, with the accompanying costs reported separately as an expenses item.

Expanded margin approach

24. The expanded margin approach would not only show the released ‘net’ margin as revenue, but would also include parts of the premium that cover some or all of the insurer’s costs, for example:

    (a) the insurer’s expenses from providing the services under the contract

    (b) the expected (probability-weighted average) insurance losses.

25. Such an approach would mitigate some of the issues with a collapsed margin because the revenue line would be more akin to the part of the premium that the policyholder pays for the services under the contract. This approach, in contrast to unbundling, does not separate the premium for a contract into its separate components but uses expected cash flows on, presumably, an aggregation level higher than the individual contract (eg portfolio basis) to approximate the part of the premium that relates to services under the contract.

26. However:

    (a) the expanded margin approach that seeks to incorporate all elements of the premium relating to the insurance coverage and other services would probably still differ somewhat from the part of the premium that is for services. So it may not be an exact presentation of the actual customer consideration.

    (b) an expanded margin approach arguably would be more complex to apply; for example, how would embedded derivatives and participating dividends be treated? Without a proper anchor (eg the premium), the revenue reported in the expanded margin approach may become a computation rather than a depiction of an actual measure or indicator.

    (c) an expanded margin presentation may not be as close to an analysis by profit driver as a summarised margin presentation.

Use locked-in or updated information

27. If one wants to use a margin model, one has to decide whether the elements of that model are determined at inception and not updated subsequently or based on updated numbers, for example:

    (a) Should the release of the margin be based on the margin determined at inception or should it also include updates of the margin (which is particularly relevant if any parts of the margin are remeasured)?

    (b) Should the expanded margin approach use elements such as expenses and claims determined at inception or should it take into account the most recent estimates for those elements?

28. Using the information determined at inception arguably means that the revenue line stays closer to (a part of) the actual customer consideration, at least closer than for a margin approach that uses updated information. However, using amounts determined at inception means that the insurer would have to track historic information, which might be complex and onerous. Under a margin approach that uses updated information, tracking of historic information would not be necessary. The examples in the appendix illustrate some of these issues.

Application of the presentation models

29. It is likely that, without further consideration, the presentation of the insurer's performance statement would result in the use of a performance statement with two presentation models. For example:

    (a) the boards may decide to require or permit a second measurement approach for some types of contracts. The IASB has decided tentatively to require an unearned premium model for pre-claim liabilities of short-duration contracts, which would present earned premiums as revenue and would not generate explicit margin information. Such a model would be irreconcilable with a margin-based model.

(b) the insurer might also have other activities, such as managing mutual funds, that would be reported under the future revenue recognition model, which is expected to report gross inflows. Such a model would also be irreconcilable with a margin-based model.

30. We identified therefore three ways forward for selecting the model(s) for the presentation of the performance statement:

(a) prescribe one presentation model for an insurer's performance statement. This would result in one single presentation of the performance statement. However, the selected approach may not be useful for all types of contracts. Furthermore, a consequence may be that the selected model would also have to be used for contracts that are accounted for under other standards, even if those standards apply a different presentation model.

(b) seek one consistent presentation model by selecting a common basic principle for what should be presented, with the revenue line as a common factor. Considering consistency with the revenue recognition project, staff believes that, if the boards were to define such a principle, each of the models should seek to present as premium part of the premium for services provided under the contract.

(i) for some presentation models, notably the earned premium model and (for some contract types) the fee model, this information would be readily available.

(ii) for the expanded margin model, this information is not readily available. But the expanded margin approach could be implemented in a way that tries to depict the customer consideration for the services provided by including in that reported revenue line some or all of the claims and expenses. [A summary margin approach would not be applicable if the aim is to present gross inflows as revenue].

(c) allow separate presentation models to exist for different types of contracts, resulting in a performance statement with more than one presentation. Because staff believes the earned premium approach and the fee model would be quite similar if the deposit component is relatively small and/or most of the premium is viewed as a prepayment for a service, this would in practice result in:

  (i) one presentation for contracts that report the customer consideration for services provided under the contract on an earned basis.

  (ii) one presentation for contracts that apply a margin-based approach.

31. Considering the analysis in this paper, all three ways forward have their issues, such as:

  (a) Consistency with other accounting models.

  (b) Comparability within the performance statement.

  (c) Relevance of the information.

  (d) Presentation of historic versus updated information.

  (e) Cost versus benefit considerations.

32. Staff will continue to investigate the presentation models and their advantages /disadvantages in order to develop a structure for the performance statement. During this meeting, staff is seeking input from the boards that might help the staff in further developing those models.

Question 3 for the boards
Have you identified any other presentation models that the boards should consider? Dou you need more information to select a presentation model (or presentation models)? Do you have any other comments?

Appendix: Examples of Presentation Models

The following fact pattern is designed to illustrate the four presentations discussed in paragraph 6 of this agenda paper. To focus on the style of presentation rather than recognition and measurement, the examples are simple and all use the same fact pattern, as follows:

- 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 number below are presented in CU1,000).
- At inception, the expected claims (including claims handling costs) are CU900.
  - Death benefits: CU50 is paid on 30 June and CU50 on 30 December.
  - Maturity benefits: CU800 on 31 December.
- Other expenses associated with the administration of the contracts CU80, incurred evenly through the period.
- Expected investment return 8 per cent and risk free rate used to discount the liability cash flows 5 per cent.
- The insurer estimates a margin at inception of CU65. The insurer requires a risk margin at inception of CU40. Therefore, the residual margin is CU25. Both the risk margin and the residual margin are released evenly over the coverage period.
- At June 30, the actual death benefits are CU60. As a result:
  - The insurer estimates that the claims for the remaining period will increase by CU15 to CU65.
  - The insurer also increases its remaining risk margin by CU5 to CU25 because of the increase in risk associated with the remaining cash flows.

    [For the purpose of this example, these changes in assumptions of in total CU 20 will be recognised in profit or loss. Alternatively, the remaining

residual margin of CU12.5 could have been adjusted for these changes in assumptions, with the remaining CU7.5 charged to profit or loss].

- At December 30, the actual death benefits are CU75.
- No differences between actual outcomes and previous estimates for other assumptions.
- The examples have significant simplifications, for example acquisition costs and no lapses. Furthermore, the examples ignore the impact of mortality experience for the maturity benefits.
- Rounding differences may exist.

Example 1 Written premium presentation

	Inception 1 Jan	six months to 30 Jun	six months to 31 Dec
Premium revenue	1,000		
Investment income		40	38
Total income	1,000	40	38
Claims and benefits		60	875
Change in insurance liability	1,000	(79)	(921)
Expenses		40	40
Acquisition costs	0		
Total expenses	1,000	21	(6)
Profit	0	19	44

Balance sheet

	1 Jan	30 Jun	31 Dec
Cash	1,000	940	63
Insurance liabilities	(1,000)	(921)	
Equity	0	19	63

Comments:

1. The whole premium is reported as revenue on receipt.
2. 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 Earned premium presentation

	Inception 1 Jan	six months to 30 Jun	six months to 31 Dec
Premiums revenue	0	500	500
Investment income		40	38
Claims and benefits		60	875
Change in insurance liability		421	(421)
Expenses		40	40
Acquisition costs	0	0	0
Total expenses	0	521	494
Profit	0	19	44

Balance sheet

	1 Jan	30 Jun	31 Dec
Cash	1,000	940	63
Insurance liabilities	(1,000)	(921)	
Equity	0	19	63

Comments:

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

2. Though not as big as under the written premium model, the changes in insurance liabilities still show significant movements. This arguably shows that an earned premium approach is useful only if the deposit components is relatively small or can be seen as a prepayment for services under the contract.

3. An alternative presentation (with a slight variation) would have been to adjust the amount recognised as revenue for time value of money.

Example 3 Unbundled (fee) presentation

	Inception *1 Jan*	*six months to 30 Jun*	*six months to 31 Dec*
Fee revenues		123	125
Policyholder benefits		(60)	(75)
Expenses		(40)	(40)
Release from insurance risk		0	20
Insurance margin		23	29
Changes in estimates		(20)	0
Acquisition costs	0		
Net gain at inception	0	0	0
Investment income		40	38
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	15
Profit	0	19	44

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	1,000	940	63
Insurance liabilities	(1,000)	(921)	
Equity	0	19	63

Comments:

1. 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 death benefits (claims) and expenses, plus the margins released in the period, all determined at inception. (The margin presentation in example 4 shows as revenue only the release of those margins.)

2. The release from insurance risk in the second half year of CU20 reflects the release of remeasurement of the insurance liability at June 30 as a result of the increases in expected claims (CU15) and risk margin (CU5). The remeasurement of the insurance liability is recognised in profit or loss in the first half year.

Example 4 Summarised Margin presentation

	Inception 1 Jan	six months to 30 Jun	six months to 31 Dec
Risk margin		21	26
Residual margin		13	13
Insurance margin	0	33	39
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Acquisition costs	0		
Net gain at inception	0	0	0
Investment income		40	38
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	15
Profit	0	19	44

Balance sheet

	1 Jan	30 Jun	31 Dec
Cash	1,000	940	63
Insurance liabilities	(1,000)	(921)	
Equity	0	19	63

Comments:

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.

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

2. Insurance margin refers to the difference between the margin at the start of the period and the margin at the end of the period. Thus, it represents the sum of (i) the risk margin attributable to risk borne during the period (ii) if applicable,

remeasurement of the risk margin during the period (iii) release of the residual margin.

Example 5 Expanded Margin presentation

	Inception *1 Jan*	*six months to 30 Jun*	*six months to 31 Dec*
Revenue		123	125
Policyholder benefits		(50)	(65)
Expenses		(40)	(40)
Release from insurance risk		0	20
Insurance margin		33	39
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Acquisition costs	0		
Net gain at inception	0	0	0
Investment income		40	38
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	15
Profit	0	19	44

Balance sheet

	1 Jan	*30 Jun*	*31 Dec*
Cash	1,000	940	63
Insurance liabilities	(1,000)	(921)	
Equity	0	19	63

Comments:

1. The amounts shown as revenue are computed as the expected value of death benefits (claims) and expenses, plus the margins released in the period, all determined at inception. (The margin presentation in example 4 shows as revenue only the release of those margins.)

2. The release from insurance risk in the second half year of CU20 reflects the release of the remeasurement of the insurance liability at June 30 from the increases in expected claims (CU15) and risk margin (CU5). The remeasurment of the insurance liability is recognised in profit or loss in the first half year.

3. Alternatively, the revenue amounts could be determined from updated amounts. In that case, the release from insurance liabilities in the second half year of CU20 would have been included in the revenue line, resulting in revenue of CU145.