IFRS	**Insurance Working Group**	Agenda reference	**4C**
	Staff Paper	Date	**November 2010**

Project	**Insurance Contracts**
Topic	**Release of the Composite Margin**

Purpose of this paper

1. This paper discusses how the composite margin should be recognised in earnings (profit or loss) after initial recognition.

2. This paper does not deal with the question whether the residual / composite margin should be re-measured or locked-in. Agenda paper 3C addresses this issue.

The proposals in FASB's Discussion paper *Preliminary Views on Insurance Contracts*

3. The DP proposes that the release pattern of the composite margin should reflect: (paragraph 83)

> the uncertainties about the amount and timing of expected net cash flows […] using the following ratio[12]:

$$\frac{\text{(Premiums allocated to date + Claims and benefits paid to date)}}{\text{(Total expected premiums + Total expected claims and benefits)}}$$

4. The proposed method for subsequent recognition of the composite margin was designed to reflect an insurer's performance under a contract, expected claims and benefits, release from risk, and insurance protection provided (period of coverage).

[12] The ratio is described as the following formula in the appendix to the Basis for Conclusions of the IASB's Exposure Draft:

$$\frac{\text{(Premium allocated to current period + Current period claims and benefits)}}{\text{(Total contract premium + Total claims and benefits)}}$$

To better clarify the manner in which the composite margin would be recognized in earnings, the components of the ratio have been revised as described above.

5. Under this approach: (paragraph 87)

> […] the portion of the composite margin recognized in the current period would be based on the protection component (premium) of the contract and the insurer's exposure to risk from uncertainties related to cash flows that may arise from claims and benefits. The ratio likely would result in a greater amount of the composite margin recognized during the coverage period to reflect the insurer's exposure to risk during that period.

Subsequent recognition in earnings

6. The proposed method for subsequent recognition of the composite margin was designed to reflect an insurer's performance under a contract, expected claims and benefits, release from risk, and insurance protection provided (period of coverage). See the Appendix for alternative drivers for recognition of the residual and composite margins in earnings that were considered by the boards.

7. Most of the initial feedback received indicates that stakeholders who support the composite margin approach agree that the composite margin should be recognized over both the coverage and claims handling periods. However, some stakeholders disagree with the manner in which the composite margin would be recognised over those periods.

8. Some claim liabilities may be fixed but the payment may be over a long period. For example, structured settlements, some worker's compensation claims or claims subject to procedural delays in payment, such as some claims for the World Trade Center, might have long periods before payment. In these situations, most of the costs to adjudicate the claim have been incurred at the end of the reporting period and only the payment and closing the claim are still required. However, the claim liability outstanding could be significant. Some stakeholders argue that the composite margin should be recognized as income prior to the final payments in these situations because the costs have been recognized and the profit is known.

9. Those stakeholders also question why the obligation remaining after the insurance component of a contract has expired is not considered a financial instrument that would be accounted for under that guidance. According to that view, the composite margin would be recognized only over the coverage period to reflect the profit earned from providing insurance coverage.

Questions
1. Do you agree with the proposed ratio to release the composite margin over time? Should the subsequent measurement of the composite margin take into account explicitly any measure of risk? 2. Do you think that the boards should prescribe a single method to recognize the composite margin in earnings after initial recognition? 3. What method(s) do you think would result in recognition of income that most faithfully represents the economic drivers of the insurer's activity?

Appendix

Drivers for subsequent recognition

1. The boards considered various prescribed drivers for subsequent recognition of the residual and composite margins and also considered not prescribing a driver but instead, allowing an insurer to select the driver(s) that would result in recognizing the margin in income in a systematic way that best depicts the insurer's performance under the contract. Additionally, different contracts may need different patterns of profit recognition depending on the terms and features of those contracts. Some drivers to consider for the subsequent recognition of the margin in earnings are the following:

    (a) Release from risk;

    (b) Expected claims or benefits;

    (c) Performance under the contract;

    (d) Liability carrying amount;

    (e) Premium receipts;

    (f) Passage of time;

    (g) Funds under management; and

    (h) A combination of two or more of the above.