IASB/FASB Meeting
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Staff Paper

Insurance contracts

Topic **Alternative Presentation Models**

Please note this paper was originally posted as IASB Agenda paper 2H for the March 1st-2nd 2011 IASB/FASB joint meeting. All paper references within refer to the Agenda paper numbering from that meeting. No other changes have been made.

Objective

1. The purpose of this paper is to present to the boards alternative presentation approaches for the performance statement for insurance contracts.
2. This paper also provides a discussion of a definition of revenue and the effect on the alternative presentations as well as some considerations of a standardized definition of operating income as a performance measure.
3. This paper does not discuss other issues related to presentation, which will be subject to future Board discussions. Those include:
   (a) How the statement of financial position should be presented
   (b) Whether any amounts should be presented in OCI
4. This paper does not ask the Board for a decision on a definition of revenue or a presentation alternative. The staff believes the boards may want to resolve other

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aspects of the insurance contracts model prior to finalizing presentation. Some of those may include:

(a) Whether premiums will be unbundled.

(b) Which cash flows are included in, or excluded from, the net insurance liability.

(c) Whether to retain the modified approach for short duration contracts.

However the staff thought it would be helpful for the boards to consider the alternatives and to keep them in mind as they deliberate the other components of the model.

5. The rest of the paper is set out as follows

(a) Background

(b) Revenue recognition criteria

(c) Presentation alternatives

(d) Appendix A: Performance statements of the alternative models

(e) Appendix B: Transpositions of the alternative models to the traditional income statement under current U.S. GAAP.

Background

6. As previously described in the February 2011 *Presentation refresher* memo (AP 3K/Memo 58K) the Exposure Draft *Insurance Contracts* (ED) and the Discussion Paper *Preliminary Views on Insurance Contracts* (DP) proposed a summarised margin presentation approach that highlights the underwriting margin, experience adjustments or changes in estimates and interest on insurance contract liabilities. For contracts measured under the modified approach, the ED proposed that the entity would separately present premium revenue (determined as the gross amount of the preclaims obligation earned in the current period), claims and expenses incurred, and the amortization of incremental acquisition costs included in the

preclaims obligation. The DP also included two alternative premium presentation approaches, the written premium approach, where premiums would be presented as revenues when receivable, and the allocated premium approach, where revenue would be recognized as the insurer performs under the contract by providing insurance coverage.

7. The alternatives in this paper are in response to the feedback that many respondents, including a majority of users, find the information given by a margin-based approach helpful and valuable. However, there is not an overwhelming support for the summarised margin presentation approach, because it eliminates from the statement of comprehensive income information about premiums, benefit payments and claims expenses. Many users state they want to see such information in the statement of comprehensive income. Some are uncomfortable with providing this information only in the notes, because they see such information as key to providing insight into the amount of new business written by insurers and the strain that this new business places on the resources of the insurer.

8. Providing a revenue figure also allows for comparability to entities that recognize revenue under the modified approach and across other industries. Some constituents voiced concern that only showing a margin released does not allow insurers to be compared by sales-based metrics.

9. Based on this feedback, the staff believes the boards need to consider alternatives to the summarized margin approach for both short and long term contracts.

Revenue recognition criteria

10. In the boards' Exposure Drafts *Revenue Recognition,* an entity would recognize revenue when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service. Hence revenue relates not to activity, but rather to satisfying the performance obligation in the contract. Entering a contract creates a performance obligation. As performance occurs, the obligation is reduced by the proportional value of the services provided or goods transferred to the customer. Therefore revenue is recognized as the liability for the performance obligation

decreases. Insurance contracts were scoped out of the *Revenue Recognition* ED and the boards decided to address the issues in the Insurance contracts project.

11. As discussed in the *Presentation refresher* memo, if the boards were to allow premiums to be recognised as revenue, the following issues arise:
    (a) What method to use to present revenue; and
    (b) Whether all elements of the premium, and in particular the deposit element, are revenue.
    (c) To be clear, this is for presentation purposes, not to override the measurement model

12. The staff has identified three methods of recognizing premium revenues:
    (a) When due, with amounts that relate to future periods added to insurance liabilities, (this was described as the "as written" approach in the DP, and is the traditional life model for recognizing premium revenue) or
    (b) As 'earned' through performance under the contract (this was described as the "allocated premium" approach in the DP, and is the traditional non-life model).
    (c) As written (expected cash flows), where the total expected present values of cash inflows and cash out flows are presented at contract inception for new business written during the period.

Advantages and disadvantages of the when due approach

13. An advantage of the when due approach is that, if all deposit components are excluded, reported revenues would correspond in total amount with the customer consideration received for the premiums, which is consistent with the ED on revenue recognition (though the timing of their recognition as revenue would, in most cases, be different). In addition, this would be consistent with how insurers in most countries recognize revenue under their current accounting.

14. The amounts recognized as revenue could be limited to those which were not refundable, and therefore could be applied to the non-life policies as well as life

policies. For example, a policyholder pays 1,200 on 1 January for auto coverage for the year. If the policyholder sells their car on 28 February and no longer needs the policy, the insurer will refund 1,000 for 10/12ths of the premium not earned. That same policyholder pays a single premium of 12,000 on 1 January for a traditional life product. If they die on 28 February their beneficiary will receive the death benefit but there is no return of premium.

15. A disadvantage of the when due approach is that the pattern of premium payments may not reflect the services provided by the insurer during the contract period therefore resulting in potentially recognizing revenue before services are performed. In this respect, the when due approach is inconsistent with the revenue recognition ED.

Advantages and disadvantages of the earned approach

16. Like for the when due approach, an advantage of the earned approach is that reported revenues would correspond with the customer consideration received for the premiums, which is consistent with the ED on revenue recognition. Additionally, by allocating the premium, the pattern of recognition could be aligned with the period over which service is performed.

17. A disadvantage of the earned approach is that the allocation of the premium or part of that premium would be inherently difficult for some types of insurance contracts (for example immediate annuities, stop-loss contracts, and contracts that contain significant deposit components or guarantees or options).

18. Some have suggested allocating expected premiums under the policy to the expected periods of claims and benefit payments however, this could result in an imputed number reported as revenue based on claims, rather than an amount that can be derived directly. The boards had previously rejected such an approach, in their discussions of an expanded margin approach in the ED/DP. Another suggestion to derive earned premium is to recognise as revenue the change in the expected present value of cash in-flows less out-flows, plus interest accretion on the liability. However, this is still difficult with certain long duration contracts, especially for life contracts with cash values. Additionally, some have suggested

that such an allocation may not be viable for contracts with significant investment components, which could result in different models of recognition between short and long term contracts. The staff is still exploring other ways to derive an earned premium that can be applied consistently across product types.

Advantages and disadvantages of the as written (expected cash flows) approach

19. An advantage of the written (expected cash flows) approach is that it is consistent with the measurement of the net insurance liability. Insurers applying the proposed liability measurement model would only need to rely on data already existing to implement this approach. In this alternative, like in the summarized margin approach, no "revenue" amounts are displayed, but rather the components of the building block are presented for contracts written during the period. This could be applied to both short and long term contracts.

20. A disadvantage of the written (expected cash flows) approach is that it is inconsistent with the revenue recognition model, in that the present value of the contract cash inflows and outflows are presented at inception, rather than as the insurer performs under the contract.

Deposit component

21. As discussed in paragraph 13, another challenge is whether all elements of the premium, and in particular the deposit element, are revenue.

22. Certain contracts have significant deposit elements. The issues are whether and how to define the elements to unbundle and account for separately.

23. The boards could define deposits and require their unbundling if the components of the premium are specified explicitly in the contract. The advantage of this approach would be that for contracts with explicitly unbundled charges, those total cash inflows (premium revenues) would exclude the deposit component. Similarly, payments that represent a return of policyholder balances from these accounts would not be reported as expenses.

24. Others believe that advance funding is inherent in the provisions of all long-duration contracts, even when those individual measurements are not explicitly

communicated as such to policyholders. For example, some believe that amounts assessed for mortality protection often result in expected cash inflows exceeding expected cash outflows in early years by a larger margin than is produced from those same amounts assessed in later years. They maintain, therefore, that a portion of early mortality assessments represents compensation for services to be provided in future periods. Others believe that the profit attributed to mortality assessments in early years, however, is the result of the recently completed underwriting process rather than of the collection of amounts assessed before they are earned.

25. The disadvantage of requiring unbundling based on the contract terms is that contracts with similar economic results but different explicit terms could be accounted for significantly differently.

26. Additionally, as the boards indicated in developing the ED/DP, for measurement purposes an unbundled approach could be arbitrary and costly to apply, particularly for contracts that do not have explicitly unbundled charges. Further the boards decided for the ED and DP that if unbundling was not required for measurement, that it would not be required for presentation.

27. The disadvantage of not requiring unbundling is that if the boards require a presentation approach including premiums, the premium revenue amounts and expenses would be grossed up for asset purchases for contracts with explicit policyholder accounts (unit-linked, segregated or separate accounts, etc.).

Discussion points

Questions for the boards
1) What is the reaction of the boards to the inclusion of revenue in the statement of comprehensive income? 2) Do the boards have any preferences?

Presentation Alternatives

Considering comments received (summarized in the *Presentation Refresher* memo), the staff developed alternative presentation approaches with examples. For comparative purposes we included an example of the traditional approach under current US GAAP (Appendix A-1) and the presentation model proposed in the ED (Appendix A-2) is included. Examples illustrating the alternative approaches include:

(a) Summarized margin with volume disclosure on the face (Appendix A-3)

(b) Expanded margin (Appendix A-4a, 4b, and 4c)

(c) As written (expected cash flows) (Appendix A-5)

(d) Dual statement (Appendix A-6)

28. We intend the examples to show, at a very high level, the rough 'feel' of different approaches. At this meeting, we do not intend to discuss precise details on how any of the approaches might apply in practice. Therefore, we suggest that Board members focus their review of the examples on the overall presentation, rather than specific details.

29. Appendix B is included for informational purposes to assist the Boards in understanding how each alternative method was translated from the traditional approach.

Statement disclosure approach (Appendix A-3)

30. Another alternative the boards may wish to consider is a disclosure on the face of the statement approach. In this approach the volume information is provided on the statement of comprehensive income but is not a component of the income. Appendix A-3 illustrates this approach.

Advantages of an on-statement disclosure approach

31. The advantage of the statement disclosure approach is that it provides the volume information on the face of the statements while retaining the summarized margin information. Unlike the expanded margin approach, because the volume information is supplementary, there is not a need to include an amount to offset the gross up effects of including the premiums within the statement of comprehensive income. This may more clearly depict the true driver of the underwriting result.

Disadvantages of an on-statement disclosure approach

32. Like the expanded margin approach, the on-statement disclosure approach would require a revenue recognition criteria and possibly unbundling. Additionally it may not be clear how the amounts reported supplementarily related to the amounts in the statement of comprehensive income, because they would not articulate with those amounts.

Expanded margin models (Appendix A-4)

33. The boards initially considered an expanded margin approach that grosses up the margin for expenses built into the liability measurement model to arrive at a revenue figure. The boards concluded that operationally this would be very costly to track and may not show a clear relation between the numbers in the performance statement and the statement of financial position. Additionally, they rejected this approach because revenue was a number derived from expected or actual expenses rather than directly determined.

34. To address this concern, the expanded margin examples included in this paper do not derive revenue from the margin. Rather, as described in paragraph 12 the revenue number in the expanded margin examples (A-4a, 4b, and 4c) is reported based on a recognition criterion. The expenses incurred that relate to the measurement model are reported beneath the revenue line and an item for changes in liability reduces the bottom-line impact of these numbers to zero. This is similar to a traditional presentation (A-1) where revenue is recognized and offset by an expense for the change in the liability. When compared to the traditional approach,

these examples preserve the useful information in a margin approach and provide more transparency into the reasons for the changes in the liability. The release of the margin(s) and various adjustments contribute to the underwriting result.

35. The three expanded margin approaches presented vary in the organization of line items. This specific issue of how to organize the line items would be explored in greater detail if the Boards were to indicate a preference for this approach.

Advantages of an expanded margin approach

36. The presentation of revenue with various expenses provides the volume information commonly used to evaluate an insurer's performance. It allows for the analysis of underwriting growth and various loss and expense ratios. This information is not discernible under a summarized margin.

37. Some believe that the expanded margin also provides greater transparency into the drivers of the margin(s) (premiums and expenses). Some respondents felt the expanded approach was aligned with the measurement of the liability since they are both connected to the cash flows of the obligation.

Disadvantages of an expanded margin approach

38. Some feel the expanded margin approach does not directly relate to the fulfilment value measurement model and as a result could be misleading because it may not be clear what the numbers and captions represent. In particular, some may consider at least one of the numbers to be a 'plug'.

Written (Expected Cash Flows) Approach (Appendix A-5)

39. The staff prepared another alternative (Appendix A-5) for displaying volume information and the margin approach. This alternative displays the total expected cash inflows and cash outflows at contract inception, for new business in the period. This model essentially results in a building block approach for all insurance contracts. These amounts subtotal to the total margin for contracts written in the

period. A portion of this margin is released along with the release of previous margins, similar to the summarized margin approach.

Advantages of a written (expected cash flows) approach

40. In this alternative, like in the summarized margin approach, no “revenue” amounts are displayed. The growth and performance measures displayed for contracts written in the period are consistent with the measurement of the liability. Some may suggest it is the volume approach that most consistently reflects the measurement model. In addition, it creates some consistency in presentation between single premium contracts and recurring premium contracts. The lack of such consistency causes some life insurers to report metrics such as ‘annual premium equivalent’ (sometimes defined as annual premiums plus one tenth of single premiums).

Disadvantages of a written (expected cash flows) approach

41. While some may believe expected cash flows for contracts written in the period are a better indicator of volume and growth, other users may still believe that the loss of premium information and claims information in this approach may have the same disadvantages as the summarized margin approach.

Dual statement approach (Appendix A-6)

42. In the dual statement approach, the statement of comprehensive income would retain the traditional income statement format and a source of earnings statement would be provided. Both statements would arrive at the same net income result. Some insurers currently present a traditional income statement and a source of earnings which includes some of the components in the summarized margin approach. The source of earnings is important to many users of the financial statements. This approach would elevate the source of earnings to a financial statement.

Advantages of a two statement approach

43. Like the expanded margin approach and the on-statement disclosure approach, the dual statement approach provides the volume information on the face of the statements while retaining the summarized margin information.

Disadvantages of a dual statement approach

44. The dual statement approach would require a revenue recognition criteria and possibly unbundling. Additionally providing the summarized margin information with a source of earnings statement may not provide the same level of prominence of this important metric compared to including it on the statement of comprehensive income.

Operating earnings

45. Operating earnings is a non-GAAP metric used by some managements to communicate to users their insurance operations. The general principle behind reporting operating earnings is often described as being to show results that are core to operations and to exclude non-core or ancillary items. Additionally, some use operating income to remove the portion of their net income that is unusual or volatile. In the insurance industry many of these adjustments are made for gains and losses on financial instruments. Typical adjustments to reconcile the net income balance to operating earnings include some or all of:

    (1) Realized investment gains/losses

    (2) Unrealized investment gains/losses

    (3) Change in discount rate

    (4) Gains/losses on derivatives (i.e. foreign currency, guaranteed life/death benefits)

    (5) Impairment on investments

    (6) Impairment on intangibles

    (7) Non-recurring items

(a) Litigation awards/settlements

(b) Extinguishment of debt

(c) Income/loss from discontinued operations

46. Many respondents suggested including operating earnings in the statement of comprehensive income to reduce the number of non-GAAP reconciliations that are provided by companies to explain their business to investors. Some have suggested that the boards should adopt a uniform measure of operating income as a performance measure for insurance contracts to enhance comparability between entities. Others believe that operating income should be entity specific and consistent with how management operates the business.

47. Several respondents expressed concern that short-term fluctuations in discount rates that do not reflect the change in the credit spread of the assets backing those liabilities creates an accounting mismatch that does not faithfully represent the economics of the underlying transactions. Life insurance entities have argued that reflecting duration mismatches that are economic in nature is appropriate, however because these entities will be forced to report assets at fair value through profit or loss, the resulting mismatch between fair value and current value is accounting volatility and not economic.

48. The inclusion of operating earnings in the statement of comprehensive income could provide a way to isolate this volatility. However, some believe splitting the statement of comprehensive income into operating and non-operating earnings deemphasizes economic volatility that is present in the core operations. In addition, some find it hard to argue that asset and liability management is not part of the core operations of an insurer.

49. It may be beyond the reasonable scope of this project to consider whether to develop a comprehensive definition of operating earnings. That would require the Boards to consider whether to include or exclude many items not related to insurance contracts. However, the staff does intend to consider whether it would be appropriate to segregate in some way within profit or loss (net income) some

components of the changes in the measurement of insurance contracts and related investments.

Discussion points

Questions for the boards
1) What is the reaction of the boards to the inclusion of operating earnings in the statement of comprehensive income?