IASB/FASB Meeting
Week beginning 16 May 2011

IASB Agenda reference	**3G**
FASB Agenda reference	**68G**

Staff Paper

Project	**Insurance contracts**
Topic	**Composite Margin – Conceptual Analysis**

Purpose of this paper

1. The purpose of this paper is to provide the boards with a conceptual analysis of the composite margin. The analysis aims to prove the composite margin does meet the objectives of financial reporting and provides users of financial statements with decision useful information that is relevant and faithfully represents what it purports to represent (ie the potential profit of the contract at risk).
2. The staff provided an overview of the composite margin and a summary of the feedback received to date as part of agenda paper 3E/68E.
3. This paper does not discuss potential changes to the profit realization of the composite margin. The staff discusses that topic at agenda paper 3F/68F.

Structure of this paper

4. The remainder of this paper is structured as follows:
   (a) Summary of staff conclusions
   (b) Background
   (c) Staff analysis
      (i) Fundamental characteristics
         (a) Relevance
         (b) Faithful representation
      (ii) Enhancing Characteristics

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(a) Comparability

(b) Verifiability

(c) Understandability

(d) Timeliness

(d) Staff conclusion

Summary of staff conclusions

5. A single margin approach with subsequent profit realization calculated using a ratio that contemplates the variability of cash flows and future expectations of cash flows provides decision useful information that is understandable to the users of financial statements, is relevant and faithfully represents the economic phenomena (potential profit at risk) it purports to represent. These characteristics are enhanced by the comparability, verifiability, timeliness, and understandability of the measure.

Background

Summary of the FASB's preliminary views

6. The DP states that, at initial recognition, an insurer should measure an insurance contract initially as the sum of the following:

   (a) The present value (unbiased estimate) of the expected cash outflows less cash inflows that are expected to arise as the insurer fulfils the insurance contract

   (b) A composite margin that represents the excess of the expected present value of cash inflows over the expected present value of the cash outflows.

Staff Analysis

7. Although a conceptual analysis was performed for the risk adjustment and presented to the boards in February of 2011, no such analysis has been performed on the composite margin to date. The staff thought it appropriate to perform such an analysis so that the boards could equally compare the two methodologies when deciding on a final model for insurance contracts. The staff prepared this analysis using Chapter 3 of the FASB's Statement of Concepts No. 8 *Qualitative Characteristics of Useful*

Financial Information (CON 8) to analyze the composite margin. The staff used CON 8 as a basis for discussion because the composite margin was presented as the FASB's preliminary view in the DP. The staff notes that the concepts discussed here are substantially identical to the IASB's concept statement.

Fundamental Characteristics

8. Paragraph QC5 of CON 8 states:

    (a) The fundamental qualitative characteristics are *relevance* and *faithful representation*.

Relevance

9. Paragraph QC6 of CON 8 defines relevance as information that:

    (a) [...] is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already are aware of it from other sources.

10. The composite margin, by definition, is the difference between what the insurer expects to earn in premiums (cash inflows) and pay out over time (fulfilment cash outflows). Thus, at initial recognition, a single margin approach provides a benchmark for the total potential profitability of the insurance contract that remains at risk due to uncertainty of the expected cash outflows.

11. Some would argue that without an explicit measure of risk at inception of the contract, that there is potential for an understatement of the liability, thus overstating potential profitability, thereby diminishing the relevance of the measure. However, some staff would disagree with this assessment because they believe that at initial recognition, the pricing of the contract would contemplate the risk that the actual cash flows would differ from the expected cash flows and thus this risk amount is included in a single margin approach. The staff believe this is a reasonable assumption given that most entities do not set out to enter into onerous contracts. Consequently, the staff do not believe the exclusion of an explicit risk adjustment diminishes the relevance of the information provided.

12. In subsequent periods, a single margin approach would include a mechanism to recognize profit as the insurer is released from risk. Consequently, what remains of the

single margin is an amount with exposure to uncertainty and therefore recognition of profit would not be appropriate because the insurer is still exposed to risk through variability in the cash flows (ie. the actual cash outflows could differ from the expected cash outflows).

13. The single margin accomplishes this by calculating a baseline ratio of actual claims reported to total expected cash outflows, adjusting that ratio for remaining variability in the cash outflows, and then multiplying that adjusted baseline ratio by the remaining margin. The key point of relevance for the single margin approach is the adjustment made to the baseline ratio and by extension the remaining margin still subject to risk. This adjustment is based upon the facts and circumstances about the claims development with respect to that portfolio and should consider the following:

    (a) The entity's relative experience with the types of contracts,

    (b) The entity's past experience in estimating expected cash flows,

    (c) Inherent difficulties in estimating expected cash flows,

    (d) The relative homogeneity of the portfolio and within the portfolio, and

    (e) Past experience not being representative of future results.

14. The consideration of the above facts and circumstances would also contemplate how the assessment is affected by where the claim is in the life cycle. The insurer considers the following times in the life cycle:

    (a) Has the claim been incurred but not yet reported?

    (b) Has the claim been reported?

    (c) Have the parties to the contract agreed upon a settlement amount?

    (d) Has the claim been paid?

15. This adjustment can, and should be, different for entities and portfolios with differing risk profiles. The adjustment to this ratio takes the single margin approach from a formulaic representation of run-off to a relevant portrayal of the potential profit at risk because of the remaining variability in the cash flows. As demonstrated in agenda paper 3F/68F, this assessment is critical to providing relevant information to the users of financial statements, otherwise profit recognized would have no relationship to the exposure an insurer has to remaining risk.

16. Additionally, the single margin approach subjects the realization of profit to current experience and estimates through the use of the total expected cash outflows in the denominator of the baseline ratio. Changes in this amount could have the ability to confirm or change a user's estimate of profit recognition and by extension the potential profit that is still subject to risk.

17. Some staff believe that the single margin approach with recognition of potential profit in the manner described above provides information that is capable of making a difference in decisions made by users.

18. Paragraph QC7 of CON 8 also states:

    (a) Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both.

19. Paragraph QC8 of CON 8 states:

    (a) Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

20. Paragraph QC9 of CON 8 further states:

    (a) Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.

21. Some staff believe the single margin approach has predictive and confirmatory value. Specifically, the single margin approach provides a benchmark for potential profit at initial recognition while providing an ongoing assessment of the amount of potential profit still subject to uncertainty. Furthermore, the recognition of profit can be used as an input to predictive processes to estimate profits in future periods. Additionally, because the calculation with the adjusted baseline ratio includes current estimation of cash outflows, these estimates can be used to confirm or change a users expectations of potential realization as discussed above.

Faithful Representation

22. Paragraph QC12 of CON 8 states:

(a) [...] To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete, neutral,* and *free from error*.

23. Paragraph QC13 of CON 8 describes a complete depiction as one that:

    (a) [...] includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. [...]

24. As stated earlier, the single margin represents the future profitability of an insurance contract that remains at risk. It is the difference between the insurers' economic resources (premiums) and obligations (claims and benefits) and that difference (ie margin) is impacted over time by the changes in expectations of cash inflows and outflows. As the certainty of those cash flows becomes clearer through the reduction in the variability of expectations, recognition of profit should occur. The uncertainty in the measure of the cash flows is inherently the uncertainty in the profitability of a given portfolio and the recognition of this profit should contemplate that uncertainty. Therefore the staff believe that the single margin approach is a complete depiction and faithful representation of the economic phenomena (ie. potential profit at risk) occurring as the insurer recognizes profit on a given contract throughout the life cycle of that contract.

25. The other important components of faithful representation are neutrality and freedom from error. Paragraph QC14 of CON 8 states:

    (a) A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users [...]

26. Some staff believe that the single margin approach provides a neutral depiction without bias. The margin itself is a function of the estimation of cash flows and profit is recognized as a result of reduction in the variability of those cash flows. The insurance contract model is based upon the unbiased estimate of cash flows and

therefore by extension the single margin approach is therefore neutral in its depiction meaning all plausible scenarios should be represented.

27. Some staff believe the uncertainty inherent in a single margin and its subsequent realization produces information that is free from errors in the context of the conceptual framework realizing that the ultimate test of these criteria is how the model is implemented in practice. Paragraph QC15 of CON 8 states:

    (a) Faithful representation does not mean accurate in all respects. Free from errors, means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. [...] For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

28. Based upon the discussion above, some staff believe the changes made to the single margin approach make it a more relevant and faithful representation of the economic phenomena it purports to represent, which is the recognition of potential profit as the insurer is released from risk.

Enhancing Qualitative Characteristics

Comparability

29. Paragraph QC20 of CON 8 states:

    (a) [...] Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

30. Some staff believe that comparability may be one of the strongest attributes for utilizing a single margin approach. As previously stated, because a single margin represents the potential profit that could be earned over the life cycle of the insurance contract, it provides a benchmark for users of financial statements to compare performance to over the long run. The staff believe the concept of expected profit realization through the release from risk as depicted by the single margin approach is

easily understood and can be compared across entities and within the entity to provide valuable input into a predictive process to enhance understanding of the entity. Specifically, users of financial statements can compare the pattern of realization of profit from one entity to another. This comparison, for example, could provide the potential to question differences in realization between entities when the nature and life cycle of the contracts appear to be the same.

Verifiability

31. Another enhancing qualitative characteristic of useful financial information is verifiability. Paragraph QC26 of CON 8 states that:

    (a) Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. […]

32. The staff believe verifiability will be less of a concern with a single margin approach because it is a function of expectations and experience based upon the reduction in the variability of the cash flows leading to profit realization throughout the life cycle of the contract. These expectations can be compared to actual results that develop over time to determine if the estimates were correct.

33. Furthermore, some staff believe if the single margin approach were to be used in conjunction with specific disclosures such as a 10 year claims development table, the testing of particular assumptions may become easier. For example, the assumptions used in the ratio for the calculation of profit realization could be compared to actual claims development to determine if these particular assumptions are appropriate.

Understandability

34. When examining the primary qualities of accounting information, it is important to keep in mind the primary users of the financial statements for which the boards are setting standards. The end users of financial statements have an indirect impact on the relevance of the information provided through their capacity to understand the information provided. As paragraph QC30 of CON 8 states:

    (a) Classifying, characterizing, and presenting information clearly and concisely makes it *understandable*.

Paragraph QC 31 of CON 8 follows:

(b) Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently. At times, even well informed and diligent users may need to seek the aid of an advisor to understand information about complex economic phenomena.

35. We do not anticipate an issue with understandability of a single margin approach nor do we foresee users requiring the aid of an advisor to understand the information presented with a single margin approach. On the contrary, we view a single margin approach as a simplification of an already complex model because this approach does not layer another complex estimate with additional assumptions on top of what is already considered a significant estimate. Furthermore, this methodology includes concepts from the loss development information, which users have indicated is critical to their analysis today.

Timeliness

36. Paragraph QC29 of CON 8 states:

(a) Timeliness means having information available to decision makers in time to be capable of influencing their decisions […]

37. The staff believe a timeliness component is inherent in the current measurement of a single margin and profit realization that is updated at each reporting period. Given that the profit realization ratio contemplates future expectations of cash flows, we believe the single margin approach provides the user with timely information that is decision useful, easy, and intuitive to understand.

Staff conclusions

38. Based upon the analysis provided above the staff believe that the single margin approach with subsequent profit realization calculated with a ratio that contemplates the variability of cash flows and future expectations of cash flows provides decision useful information that is understandable to the users of financial statements, relevant and faithfully represents the economic phenomena (recognition of potential profit at

risk) it purports to represent. These characteristics are enhanced by the comparability, verifiability, timeliness, and understandability of the measure.

Question for the boards
1) Do the boards agree with the staff analysis and conclusions? If not, why not?