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Staff Paper

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Project **Insurance Contracts**

Topic **Statement of Financial Position**

Purpose of this paper

1. The purpose of this paper is to discuss:
    (a) the statement of financial position presentation of an entity's rights and obligations under the building block and premium allocation approaches; and
    (b) the level of aggregation at which an entity should present the rights and obligations associated with its insurance contracts.
2. This paper does not address:
    (a) Presentation of unit-linked contracts and other deposit-type components.
    (b) Presentation of reinsurance.

Summary of staff recommendations

3. The staff recommend the following:
    (a) The insurer should disaggregate the following components, either in the statement of financial position or in the notes, in a way that reconciles to the amounts included in the statement of financial position:
        (i) Expected future cash flows
        (ii) Risk adjustment (for the IASB)
        (iii) Residual margin (for the IASB)

(iv) The single margin, where relevant (for the FASB)

(v) The effect of discounting

(b) For those contracts measured under the premium allocation approach, the liability for remaining coverage should be disclosed separately from the liability for incurred claims. Some staff recommend that these two items should be presented separately in the statement of financial position. Other staff believe that separate disclosure in the notes would suffice.

(c) As a change to the proposals included within the ED, the unconditional right to any premiums or other consideration should be presented in the statement of financial position as a receivable separately from the insurance contract asset or liability and accounted for in accordance with existing guidance for receivables. The remaining insurance contract rights and obligations should be presented on a net basis in the statement of financial position.

(d) Conditional rights to any premium measured under the premium allocation approach should be netted against the liability for remaining coverage if presented separate from the liability for incurred claims.

(e) The liability (or asset) for insurance contracts should be presented in the statement of financial position separately for those measured using the building block approach and those measured using the premium allocation approach.

(f) Portfolios in an asset position should not be aggregated with portfolios in a liability position in the statement of financial position. This recommendation applies to both the premium allocation approach and the building block approach.

Structure of this paper

4. The remainder of this paper is structured as follows:

(a) Background, including:

(i) a summary of the IASB's proposals and the FASB's preliminary views

(ii) a summary of the relevant comments received from respondents to the IASB's exposure draft *Insurance Contracts* (the ED) and the FASB's DP *Preliminary Views on Insurance Contracts* (the DP)

(b) Staff analysis, including:

(i) Presentation of an insurer's rights and obligations;

(ii) Presentation of the building blocks:

(a) Presentation of the risk adjustment;

(b) Presentation of the effect of discounting;

(c) Presentation of the residual margin;

(d) Presentation of the single margin

(iii) Presentation of the liability for remaining coverage and the liability for incurred claims; and

(iv) The level of aggregation in the statement of financial position.

Background

Summary of the IASB's proposals

5. The IASB stated in paragraph 69 of the ED:

> An insurer shall present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities.

Also, the IASB stated in paragraph BC156 of the ED:

> The combination of rights and obligations arising from an insurance contract is presented as a single insurance contract asset or liability in the statement of financial position, consistently with the measurement of an insurance contract asset or liability based on a package of cash inflows and outflows. Such presentation is consistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, which treat the combination of rights and obligations as giving rise to a single contract asset or liability.

6. In addition, paragraph BC148 of the ED indicates that the premium allocation approach is intended to be consistent with the building block approach. Consequently, paragraph BC148 of the ED states:

> To maintain consistency with the measurement for insurance contacts generally,…the pre-claims obligation and the expected present value of the future premiums are presented as a single insurance contract asset or liability.

7. Furthermore, paragraph 86 of the ED require the reconciliation from the opening to the closing balance of each of the following if applicable:

> (a) Insurance contract liabilities and, separately, insurance contract assets.
> (b) Risk adjustments included in (a)
>
> (c) Residual margins included in (a)

Summary of the FASB's preliminary views[1]

8. The FASB stated in paragraph 112 of the DP:

> The presentation of the combination of rights and obligations arising from an insurance contract as a single net liability or a single net asset would be consistent with the measurement of an insurance contract asset or liability based on net cash flows.

Presentation of Rights and Obligations under Current Requirements

9. Consistent with the presentation of SEC registrants, non-public US GAAP preparers and entities in most jurisdictions[2] present premiums receivable (i.e., all contractual premiums regardless of whether earned or due as of the balance sheet date), the liability for remaining coverage (i.e., unearned premium), and the liability for incurred claims separately in the statement of financial position.

10. For SEC registrants, ASC 944-201-S99 sets forth the requirement to present premiums receivable, the liability for remaining coverage (i.e., unearned premiums) and the liability for incurred claims (i.e., losses, claims, and loss expenses and claims payable) separately:

[1] The FASB did not make any tentative decisions regarding the presentation of insurance contracts in the statement of financial position leading up to the Discussion Paper. Hence, the Discussion Paper, for the most part, referred to the IASB's Exposure Draft.

[2] Note: US GAAP for insurance is currently applied wholly or partially in many parts of the world, even those that have adopted IFRS

> *Accounts and notes receivable*. Include under this caption (a) amounts receivable from agents and insureds, (b) uncollected premiums, and (c) other receivables.
>
> *Policy liabilities and accruals*. State separately in the balance sheet the amounts of (1) future policy benefits and losses, claims and loss expenses, (2) unearned premiums, and (3) other policy claims and benefits payable.

11. Thus, current practice in the U.S. and most jurisdictions is for gross presentation of the rights and obligations associated with a short-duration insurance contract.

12. The staff also noted the resemblance between the IASB ED proposal and current U.S. GAAP[9] presentation guidance for long-duration insurance contracts which is applied in most jurisdictions. ASC 944-40-25-8 states:

> The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders – that is, a liability for future policy benefits – shall be accrued when premium revenue is recognized.

Thus, current practice in the U.S. requires net presentation of the rights and obligations associated with a long-duration insurance contract which is consistent with most jurisdictions.

Overview of comments on the ED / DP regarding statement of financial position presentation

Presentation of rights and obligations under the building block approach

13. Some respondents preferred net presentation of the rights and obligations associated with an entity's insurance contracts. These respondents indicated that this form of presentation would be consistent with the proposed guidance on revenue recognition. Indeed, paragraph BC237 of the staff draft of FASB Proposed ASU *Revenue from Contracts with Customers* states:

> The Boards proposed that the remaining rights and performance obligations in a contract form a single unit of account and should be accounted for, and presented, on a net basis as either a contract asset or a contract liability. The Boards noted that the rights and obligations in a contract with a customer are interdependent.

Paragraph BC160 of the IASB exposure draft *Revenue from Contracts with Customers* also contains this statement.

14. Similarly, the right to receive premiums and retain any prepaid premiums from a policyholder depends on the insurer's performance, and the insurer will only perform if the policyholder pays premiums. Thus, some respondents indicate that net presentation of an insurer's rights and obligations would most faithfully represent the level of interdependence between such rights and obligations.

15. However, some preparers believe the disaggregated building block components of an entity's net insurance contract asset or net insurance contract liability should be presented on the statement of financial position. Specifically, these respondents are interested in separate presentation of the entity's net expected cash flows and the single margin or the residual margin and the risk adjustment. These respondents commented that greater transparency would result from disaggregation of the building block components of an entity's net insurance contract asset or net insurance contract liability on the statement of financial position.

16. Many non-life insurance respondents noted that the right of setoff does not typically exist with respect to the premiums receivable from one policyholder and the claim reserves associated with another policyholder. Paragraph 4 of the FASB Proposed ASU *Offsetting* states:

> An entity shall offset a recognized eligible asset and a recognized eligible liability only if:
>
> (a) The entity has a right to or obligation for only the net amount of the rights and obligations associated with the financial asset and financial liability, and
>
> (b) The amount that results from offsetting the financial asset and financial liability depicts the entity's expected cash flows from settling two or more distinct financial instruments.

Paragraph 4 of the IASB ED *Offsetting Financial Assets and Financial Liabilities* also contains this statement. The tentative decisions of the Boards in the *Balance Sheet - Offsetting* project have not changed this proposed guidance.

17. These respondents commenting on setoff indicated that net presentation of the rights and obligations associated with an entity's insurance portfolio would not faithfully represent the entity's economic circumstances. We assume the unit of account is the portfolio, but will discuss this topic at a future meeting.

18. The following example illustrates the presentation of an entity's rights and obligations in accordance with each of the respondents' suggestions for the building block approach.

Example 1: Assume that Best Insurer issued one insurance contract on 1 January 2011. Best Insurer has an expected loss ratio of 80%. At 1 January 2011, the present value of Best Insurer's premiums receivable is 1,200 CU, and the expected present value of Best Insurer's cash outflows to fulfill the insurance contract is 960 CU. Best Insurer's right to premiums is conditioned on its provision of insurance protection (i.e., it does not have an unconditional right to any portion of the premium receivable at this point in time). At 1 January 2011, the risk adjustment associated with the insurance contract is 140 CU, and the residual margin is 100 CU. The single margin associated with the insurance contract is 240 CU.

1 January 2011:

Net Presentation of the Rights and Obligations (i.e., the ED proposal)

Assets			Liabilities and Stockholders' Equity		
Cash	0	CU	Net Insurance Contract Liability	0	CU
			Retained Earnings	0	CU
Total Assets	0	CU	Total Liabilities and Stockholders' Equity	0	CU

Separate Presentation of the Expected Cash Flows and Other Building Block Components

Assets			Liabilities and Stockholders' Equity		
Expected PV of Net Insurance Contract Cash Flows	240	CU	Insurance Contract Single Margin[4]	240	CU
			Retained Earnings	0	CU
Total Assets	240	CU	Total Liabilities and Stockholders' Equity	240	CU

Separate Presentation of Cash Inflows, Cash Outflows, and Other Building Block Components

Assets			Liabilities and Stockholders' Equity		
Premium Receivable (expected PV of insurance contract cash inflows)	1,200	CU	Insurance Contract Liability (PV of expected insurance contract cash outflows)	960	CU
			Insurance Contract Single Margin[3,4]	240	CU
			Retained Earnings	0	CU
Total Assets	1,200	CU	Total Liabilities and Stockholders' Equity	1,200	CU

[3] The staff note the single margin and residual margin represent deferred profit and, as such, are dependent on the measurement of both the separately presented contract asset and contract liability in this presentation alternative. The risk adjustment represents 'the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract' and, as such, there is implicitly a separate risk adjustment that could be reflected for each of the separately presented contract asset and contract liability. For purposes of this example, the staff have reflected the margin as a single line item.

[4] This presentation reflects the single margin as tentatively decided by the FASB. Under a model with a risk adjustment and residual margin, the single margin would be reflected by two lines items in amounts of 140 CU and 100 CU, respectively.

Presentation of rights and obligations under the premium allocation approach

19. A small number of non-life insurance preparers and users indicated a preference for gross presentation of an entity's rights and obligations arising from an insurance contract under the premium allocation approach. These respondents believe that users would find separate presentation of an entity's premiums receivable and claim reserves to be relevant for decision-making purposes.

20. Many non-life insurance preparers and users expressed a preference for separate presentation of the liability for remaining coverage[5] and the liability for incurred claims[6] when the premium allocation approach is applied, noting that each of these liabilities convey important information to users. Some of these respondents indicated that separation of the liability for remaining coverage and the liability for incurred claims in the statement of financial position would be consistent with the Boards' tentative decisions to date regarding presentation in the statement of comprehensive income of premiums earned and claims incurred for those contracts meeting the eligibility criteria to use the premium allocation approach. Some of these respondents also noted that they believe a combined presentation of these liabilities, given the differences in the underlying calculations, would have a negative impact on the transparency and usability of the financial statements.

21. Certain respondents also indicated a preference for separate presentation of the effect of discounting the liability for incurred claims under the premium allocation approach. These respondents believe that greater transparency would result from separate presentation of the effect of discounting the net asset or net liability associated with an entity's insurance contracts. Several users believe that this would allow them to perform analyses of an insurer's liability with and without discounting more easily.

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[5] The liability for remaining coverage is defined as, 'an insurer's stand-ready obligation to pay valid claims for future insured events arising under existing contracts (i.e., the obligation relating to the unexpired portion of risk coverage)'.

[6] The liability for incurred claims is defined as, 'the liability to pay valid claims for insured events that have already occurred, including claims incurred but not reported'.

22. The following example illustrates the presentation of an entity's rights and obligations in accordance with some of the respondents' suggestions for the premium allocation approach.

Example 2: Assume that Best Insurer issued one insurance contract on 1 January 2011 that provides one year of coverage. Best Insurer has an expected loss ratio of 80%. At 1 January 2011, the present value of Best Insurer's premiums receivable is 1,200 CU, and the present value of Best Insurer's liability for remaining coverage is 960 CU. Best Insurer's right to the premiums receivable is conditioned on its provision of insurance protection (i.e., it does not have an unconditional right to any portion of the premium receivable at this point in time).

At 30 June 2011, the present value of Best Insurer's premiums receivable is 600 CU, and the present value of Best Insurer's liability for remaining coverage is 600 CU. Best Insurer's right to the premiums receivable is conditioned on its provision of insurance protection for the remainder of the contract (i.e., it does not have an unconditional right to any portion of the premium receivable at this point in time). Also, the present value of the cash outflows to fulfill Best Insurer's liability for incurred claims at 30 June 2011 is 480 CU (no claims payments during the first half of the policy). At 30 June 2011, the risk adjustment associated with the present value of the cash flows included in the liability for incurred claims is 70 CU.

30 June 2011:

Gross Presentation of the Rights and Obligations

Assets			Liabilities and Stockholders' Equity		
Cash	600	CU	Liability for Remaining Coverage	600	CU
Premium Receivable (expected PV of insurance contract cash inflows)	600	CU	Liability for Incurred Claims[7]	480[8]	CU
			Retained Earnings	120[8]	CU
Total Assets	1200	CU	Total Liabilities and Stockholders' Equity	1200	CU

Net Presentation of the Rights and Obligations (i.e., the ED proposal)

Assets			Liabilities and Stockholders' Equity		
Cash	600	CU	Net Insurance Contract Liability[3]	480[8]	CU
			Retained Earnings	120	CU
Total Assets	600	CU	Total Liabilities and Stockholders' Equity	600	CU

Level of aggregation in the statement of financial position

23. Many respondents indicated the need for clarification in the final standard regarding the intended level of aggregation in the statement of financial position. A literal interpretation of the ED proposal would require separate presentation on the face of the statement of financial position of each portfolio. Many respondents stated that such a presentation would result in an overly detailed and incomprehensible statement of financial position. Several respondents suggested that the statement of financial position should

[7] For the purpose of simplicity, the effect of remeasuring the discount is not presented in this example. As noted above, some respondents indicated a preference for presenting the effect of discounting separately. If such a presentation is followed, one would have to consider how the effect of discounting would be presented (i.e., separately for each of the cash inflow asset and cash outflow liability, etc.)

[8] The FASB tentatively concluded in its 7 September 2011 meeting that the liability for incurred claims should be measured as the present value of unbiased expected cash flows (statistical mean) without a single margin. Based on the IASB's tentative decisions, the liability for incurred claims would be increased and retained earnings decreased by 70 CU to reflect the risk adjustment. See also discussion in footnote 3 above regarding risk adjustment and the premium receivable.

disaggregate insurance contracts measured under the building block approach and insurance contracts measured under the premium allocation approach.

Staff Analysis

Presentation of an Insurer's Rights and Obligations

24. Both the IASB ED and the FASB DP proposed that the right to receive premiums, the performance obligation related to remaining coverage, and the obligation to pay benefits and claims in an insurance contract constitute a single unit of account for measurement purposes (i.e., the insurance contract is to be measured as a bundle of rights and obligations), a perspective expressed also in a number of respondent's comment letters.

25. The basis for conclusions within the IASB ED notes the board's proposal was largely influenced by the proposed guidance on revenue recognition. Paragraph BC237 of the staff draft of FASB Proposed ASU *Revenue from Contracts with Customers* states:

> The Boards propose that the remaining rights and performance obligations in a contract would form a single unit of account and would be accounted for, and presented, on a net basis as either a contract asset or a contract liability.

Paragraph BC160 of the IASB ED *Revenue from Contracts with Customers* also contains this statement. The basis for conclusions on the insurance contracts ED referenced the consistency with the revenue standard as part of the IASB's considerations.

26. As noted above, many respondents believe that, for non-life insurance products, gross presentation provides more relevant information than would be provided under net presentation, in part, because net presentation makes it more difficult to understand how much unearned premium has been written and, therefore, an indication of the magnitude of the obligation the insurer has committed to. For example and as can be seen in the first presentation alternative included above in Example 1 (paragraph 18), net presentation of the rights (i.e., premiums receivable) and obligations (i.e., incremental acquisition costs payable, the liability for future coverage, and the liability for

incurred claims) may result in a contract liability amount of 0 CU in the statement of financial position (i.e., prior to receipt of initial premium and payment of acquisition costs). Additionally, net presentation obscures the liability for incurred losses.

27. The board's proposal in the IASB ED to treat an insurance contract as a single liability or asset, without assessing individual components for separate recognition, was made, in large part, based on perceived shortcomings of evaluating individual elements of the contract as assets and liabilities. Such an evaluation had caused particular concern when it came to recognition and measurement of policyholder behaviour, future premiums (including deposit like elements), and policyholder participation.[9] Separating elements of the contract for presentation purposes into rights and obligations would be inconsistent with the measurement approach and would not faithfully represent those elements, especially to the extent the rights (or some portion of expected cash flows associated with those rights) do not qualify as assets.

Presentation of Unconditional Right to Premium

28. As indicated above, the ED proposal to treat the combination of rights and obligations existing within an insurance contract as a single contract asset or liability was based, at least in part, on ensuring consistency with the presentation proposal in the proposed revenue standard. Accordingly, the staff also considered paragraph BC243 of the staff draft of FASB Proposed ASU *Revenue from Contracts with Customers*, which states:

> Therefore, the Boards decided that once an entity has an unconditional right to consideration, the entity should present that right as a receivable separately from the contract asset and account for it in accordance with existing guidance. Consequently, contract assets are recognized in accordance with the proposed guidance when an entity has satisfied a performance obligation but does not yet have an

[9] Although the eligibility criteria for application of the premium allocation and building block approaches are still being evaluated, many of the contracts that were the subject of this concern are deemed more likely to be accounted for under the building block approach.

unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract.

Staff Recommendation

29. The staff recommend that the unconditional right to any premiums or other consideration should be presented in the statement of financial position as a receivable separately from the insurance contract asset or liability and accounted for in accordance with existing guidance for receivables. The staff think that increased comparability will be achieved by presenting the unconditional right to any premiums or other consideration as a receivable separately from the insurance contract asset or liability and accounting for it in accordance with existing guidance for receivables (i.e., ASC Topic 310 *Receiveables*, IAS 39 *Financial Instruments: Recognition and Measurement*. or IFRS 9 *Financial Instruments*). This proposed treatment of receivables is deemed consistent with the proposed revenue recognition model. The staff acknowledge that most insurance contracts require payment of premium in advance of the related coverage period (even when paid in installments over the life of the contract) but, think that such a principle is appropriate to address any material deviations from these typical payment terms that might exist.

Question 1 for the Boards:
Do the Boards agree that the unconditional right to any premiums or other consideration should be presented in the statement of financial position as a receivable separately from the insurance contract asset or liability and accounted for in accordance with existing guidance for receivables?

30. The staff recommend that the remaining insurance contract rights and obligations should be presented on a net basis in the statement of financial position. Although an insurer also does not generally have a right or obligation of setoff across contracts within an individual portfolio, offsetting such rights and obligations at a portfolio level is deemed to be consistent with the proposed measurement basis and a reasonable practical expedient.

Question 2 for the Boards
Do the Boards agree that the remaining insurance contract rights and obligations should be presented on a net basis in the statement of financial position?

Presentation of the Building Blocks

Presentation of the Risk Adjustment

31. The staff also examined the possibility of separate presentation of the risk adjustment from the remainder of the insurance contract asset or liability.

32. The risk adjustment is highly dependent on changes in estimates of the cash flows (or, at least, the possibility of such changes) and is inextricably associated with the cash flows themselves. However, the IASB has tentatively decided that the risk adjustment should be independently determined and, thus, the risk adjustment *could* be separately disclosed. Separate disclosure would provide relevant information to users, in particular because the risk adjustment fluctuates over the duration of a contract in response to changes in both the amount of risk in the contract and the entity's appetite towards risk.

33. Nonetheless, a risk adjustment cannot be considered as a standalone item or liability, but quantifies risk in the insurance contract liability. It does not meet the definition of a liability under US GAAP, Concepts Statement No. 6 *Elements of Financial Statements* (CON 6) or the IASB's conceptual framework because it does not by itself represent a present obligation of the entity.[10]

34. A more pertinent question might be whether disaggregation of the risk adjustment component in the statement of financial position would provide more, or less, information than before. Under current US GAAP there is an

[10] Paragraph 36 of CON 6 states, "A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand; (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid a future sacrifice; and (c) the transaction or other event obligating the event has already happened." The current conceptual framework under IFRS has a similar definition for a liability.

implicit margin (i.e., no day-one gain) and, for traditional and long-duration participating life insurance contracts[11], a provision for adverse development.

35. Many interested parties state that there needs to be adequate transparency of how entities' measure insurance contract assets and liabilities. Such additional transparency might be accomplished through presenting risk adjustment (and the other building block) amounts as line items in the statement of financial position or within the footnotes, which might allow for further accompanying qualitative description.

Presentation of the Effect of Discounting

36. The staff also considered the view expressed by some property and casualty insurance preparers and users that the effect of discounting the net insurance contract asset or net insurance contract liability should be presented separately in order to increase the transparency of the statement of financial position. These users have expressed concerns that, due to the relatively greater uncertainty of frequency and severity of property and casualty insurance losses, the inclusion of the effect of discounting in the statement of financial position introduces additional subjectivity and that it is important for users to be able to distinguish between the estimated undiscounted cash flows and the discount estimated by the company. However, the proposed disclosures for the loss development table will be on a nominal basis and be reconciled to the statement of financial position. Therefore, transparency into the undiscounted cash flow estimates will be available. Furthermore, the staff believe that separately presenting the effect of discounting as its own line item in the asset section[12] of the balance sheet would not be well understood by users of the financial statements, is inconsistent with the conceptual framework definition of an asset, and would lead to lack of comparability with non-insurance entities (i.e., the effect of discounting any other assets or liabilities is not required to be separately presented in the statement of financial position).

[11] The liabilities related to short duration contracts, universal life-type contracts, deferred annuities, and variable and equity-based life and annuity products do not contain a provision for adverse deviation.
[12] The effect of discounting a liability is to reduce the amount and, as such, separating the effect of discounting from the nominal cash flows and presenting as its own line item would be, generally, reflected as an asset on the statement of financial position.

37. The staff believe that disclosure of the effect of discounting the insurance contract asset or insurance contract liability is critical in order to provide users with sufficient decision-useful information. As the effect of discounting is a means to ascribe a value to the time value of money, disclosure of the estimated timing of the cash flows together with the adjustment of those particular cash flows is considered by many to be decision-useful information.

Presentation of the Residual Margin

38. The staff also examined the possibility of separate presentation of the residual margin. A number of respondents suggested that separate presentation of the residual margin would provide decision-useful information for users. The staff plans to explore in a future meeting what the residual margin represents (as this has implications for the unlocking decisions). However, the same considerations apply to the residual margin as to the risk adjustment and the effects of discounting: Although disaggregated information about the residual margin may be useful to users of financial statements, the residual margin is an integral part of the liability that arises from an insurance contract.

Presentation of the Single Margin

39. In addition, the staff considered the possibility of separate presentation of the present value of expected future cash flows and the single margin, given the fact that certain users also expressed a preference for separate presentation of the single margin. The staff noted that the single margin represents profit at risk, whereas the expected present value of cash flows represents the net right or obligation of the insurer.

40. The staff believe that the present value of the expected future cash flows and the single margin do not constitute a single unit of account for *measurement* purposes. Specifically, paragraph 73 of the FASB DP states:

> An insurer would recognize the effects of changes in the present value of estimates of probability-weighted net cash flows immediately in earnings.

41. Furthermore, the FASB has tentatively concluded that the single margin will be accreted into income as an insurer is released from risk. As a result, the

expected cash flows and the single margin are not subject to the same initial or subsequent measurement approach.

42. However, some would argue that the measurement of the single margin is linked to the variability of the expected cash flows, since the single margin implicitly reflects risk and uncertainty in these cash flows that was anticipated during underwriting. Unlike the residual margin though it is not unlocked based on changes within the estimated cash flows.

43. The staff believe that users of financial statements would be interested in viewing an entity's obligations separately from the entity's expected profit. Moreover, some believe that the face of the financial statements may be less transparent if an entity's obligations and expected profit are not presented separately.

44. As we had done in regards to the risk adjustment and residual margin, the staff considered whether a standalone single margin faithfully represents a distinct obligation or liability. Based on consideration of the guidance referred to above in the risk adjustment analyses (paragraph 33), the staff do not believe that the single margin meets the definition of a liability (i.e., deferred profit neither represents an obligation nor is indicative of future outflows / sacrifices of economic benefits).

Staff Recommendation

45. The staff believe that the risk adjustment, residual margin, single margin, and effect of discounting do not represent assets or liabilities under the framework of US GAAP or IFRS and their inclusion as separate line items on the statement of financial position would detract from the goals of understandability and comparability. However, the staff believe that transparency into each of these elements of the measurement of insurance contracts is necessary. In the event the tentative differences related to risk adjustments and margins in the FASB and IASB models survive, disclosure of these amounts may have an added benefit of allowing for easier user comparability amongst insurers applying these different models. We will consider at a later meeting whether further disclosure is needed to make the two models comparable.

Question 3 for the Boards:
Do the Boards agree that an insurer should disaggregate the following components, either in the statement of financial position or in the notes, in a way that reconciles to the amounts included in the statement of financial position: (i) Expected future cash flows (ii) Risk adjustment (for the IASB) (iii) Residual margin (for the IASB) (iv) The single margin, where relevant (for the FASB) (v) The effect of discounting

Presentation of the Liability for Remaining Coverage and the Liability for Incurred Claims

46. The staff analyzed whether the liability for remaining coverage and the liability for incurred claims should be presented together as one liability or separately as two liabilities in the statement of financial position for those contracts meeting the eligibility criteria for the premium allocation approach. Many comment letter respondents expressed support for separate presentation for non-life insurance contracts.

47. The staff considered the notion that presentation of an insurance contract in the statement of financial position should reflect the underlying calculations applied in the measurement of the insurance contract. In the premium allocation approach, the initial and subsequent measurement basis for the liability for remaining coverage differs from the liability for incurred claims. Paragraph 56 of the IASB ED *Insurance Contracts* states:

> The [liability for remaining coverage] is the pre-claims obligation, less the expected present value of future premiums, if any, that are within the boundary of the existing contract.

48. Also, paragraph 57 of the IASB ED *Insurance Contracts* states:

> An insurer shall measure its pre-claims obligation [i.e., liability for remaining coverage] at initial recognition as
> a) the premium, if any, received at initial recognition, plus the expected present value of future premiums, if any, that are within the boundary of the existing contract; less
> b) the incremental acquisition costs.

49. Similarly, paragraph 97 of the FASB DP *Insurance Contracts* states:

> The [liability for remaining coverage] is the preclaims obligation less the expected present value of future premiums, if any, that are within the boundary of the existing contract. The preclaims obligation is measured at initial recognition as the premium, if any, received at initial recognition, plus the expected present value of future premiums, if any, that are within the boundary of the existing contract less the incremental acquisition costs. Thus, the [liability for remaining coverage] at initial recognition is equal to the premiums received, if any, at initial recognition less the incremental acquisition costs.

50. Subsequently, the premium allocation approach measurement of the liability for remaining coverage is to be reduced on the basis of time or the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. In contrast to the measurement of the liability for incurred claims, paragraph 55(b) of the IASB ED *Insurance Contracts* states:

> An insurer shall measure its [liability for incurred claims] at the present value of the fulfilment cash flows.

51. Similarly, paragraph 102 of the FASB DP *Insurance Contracts* states:

> As insured events occur, an insurer would separately recognize a [liability for remaining coverage]. That liability would be measured as the probability-weighted estimate of the net cash flows under the building block approach at the end of each reporting period.

52. Some view there to only be one performance obligation, which might be described as an unconditional obligation to reimburse the policyholder for any damages suffered from an insured event. Others believe that there are two distinct pieces of the obligation: the liability for remaining coverage represents a performance obligation, whereas the liability for incurred claims represents an obligation to pay an amount for a specified event that has occurred. If we consider the guidance in the staff draft of FASB Proposed ASU *Revenue from*

Contracts with Customers by analogy, one might interpret that the performance obligation is to stand ready to assume the financial value of any insured losses and 'make whole' the insured. This interpretation would seem to be consistent with the 7 September 2011 FASB board tentative decision to earn all premium / revenue and not defer any profit beyond the coverage period (i.e., via not including a single margin in the premium allocation approach). Similarly, the IASB tentatively concluded in its 23 June meeting that insurers should allocate the residual margin over the coverage period. Under such an interpretation, the liability for incurred claims might be deemed an 'unconditional' financial obligation, analogous to an 'unconditional' payable that is separately accounted for under existing guidance for liabilities. Said another way, at the date the loss is incurred the insurance protection has been provided and the insurer has a payable that, outside the scope of the insurance contract standard, might be accounted for under ASC 405 *Liabilities* or IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets* separately from any remaining stand ready contract liability under the revenue ASU.

53. The Boards tentatively decided at the Joint Board Meeting at 15 June 2011 to include volume information relating to the underwriting results of insurance contracts (e.g., premiums) in the statement of comprehensive income. The staff noted that one of these components, premiums earned, corresponds to the liability for remaining coverage, which is commonly referred to under existing financial reporting as the unearned premium reserves. Likewise, the line item for claims incurred in the statement of comprehensive income would correspond to the line item for the liability for incurred claims, given that claims incurred are driven by the changes in the estimates of the expected cash flows. Accordingly, separate presentation within the statement of financial position of the liability for future coverage and the liability for incurred claims would link clearly with the performance measures included on the statement of comprehensive income.

54. In addition, the staff believe that users are interested in viewing the amount of the liability for remaining coverage in the statement of financial position (i.e., identifies premium written but not yet earned). Considered together with the

amount of earned premiums in the statement of comprehensive income, it is indicative of growth trends or declines in future income.

55. The staff also considered whether the liability for remaining coverage and the liability for incurred claims should be separately presented for contracts measured under the building block approach. The staff note that the two liabilities are measured in the same manner under the building block approach so separate presentation would not necessarily help users better understand the liability itself. Furthermore, because the two liabilities are measured together pursuant to the building block model approach, to require separate presentation would introduce additional costs to financial reporting that must be weighed against the potential benefits of such additional information. Another key difference is that the liability for incurred claims is generally relatively insignificant for life insurance products (i.e., once the insured event occurs, it tends to both be reported timely and the payment occurs relatively quickly). Therefore, separation would not provide as much information as it does for non-life insurance, whose liability for incurred claims is much more significant. Also, we note that the comment letter and other interested party input supporting a segregation of the two liabilities has been provided almost entirely by non-life insurance preparers and users, an indicator of the smaller perceived benefit in separate presentation for life insurance business.

Presentation of Rights to 'Conditional Premium'[13] Under the Premium Allocation Approach

56. Under current practice for short duration contracts, premium receivable is recorded at the effective date in an amount equal to the estimated ultimate premium and an offsetting liability is established for unearned premium (i.e., deferred revenue or liability for future coverage). The premium may or may not be contractually due to the insurer at this date (i.e., it might not reflect an unconditional right to consideration). Typically, if premium due isn't paid to the insurer then the policy will lapse (after a grace period) and the insurer will no longer have a liability for future coverage.

[13] References to 'conditional premium' in this paper refer to any premium that doesn't yet represent an unconditional right to premium. As defined within the FASB's Proposed ASU and IASB's exposure draft *Revenue from Contracts with Customers* "A right to consideration is unconditional when nothing other than the passage of time is required before payment of that consideration is due."

57. The staff considered whether the criteria included in the FASB Proposed ASU *Offsetting* and the IASB ED *Offsetting Financial Assets and Financial Liabilities* to set off a financial asset and a financial liability (included above in paragraph 16) would be satisfied as it relates to conditional premium receivable and either the liability for future coverage or the liability for incurred claims. Although the criteria are not expected to be consistently met (i.e., due to contract specific rights and obligations and the legal environment the contract is subject to), paragraph 3 of the IASB ED *Offsetting Financial Assets and Financial Liabilities* specifically states that the guidance is only applicable to items within the scope of IAS 39. Paragraph 2(e) of IAS 39 explicitly excludes the rights and obligations associated with an insurance contract from its scope.

58. The staff note that some insurance contracts contain provisions for retrospective premium adjustments (i.e., contractual adjustments to premiums based on the insured's loss experience under the contract) and other loss sensitive features (e.g., retrospective commissions that are determined based on the insured's loss experience). Based on these considerations, the staff think that the conditional rights to future premium arising from these retrospective premium adjustments are more closely correlated to the liability for incurred losses, whereas the conditional rights to other future premium are more closely correlated to the liability for remaining coverage. This correlation might suggest that the rights to these two differing premium types might be netted against the liabilities they are more closely correlated to.

59. However, the IASB tentatively concluded that the residual margin should be fully recognised as income over the coverage period, and the FASB decided that a single margin should not be recorded for contracts in the premium allocation approach. Both these tentative decisions suggest 100% of the premium is allocable to this stand ready obligation and none to additional performance obligations related to the post claims period. If one views the retrospective premium adjustment as an adjustment to the revenue (i.e., rather than an adjustment to the benefits owed under the contract), it would follow that even any retrospective premium adjustments would be attributed to the stand ready 'service' provided during the coverage period. Under current

financial reporting standards, retrospective premium adjustments are considered to be an adjustment to the premium.

Staff Recommendation

60. Some staff recommend that, for those contracts measured under the premium allocation approach, the liability for remaining coverage should be presented separately from the liability for incurred claims in the statement of financial position. The calculations underlying the measurement tentatively proposed by the boards differs for the two liabilities (i.e., one is based on the amount of unearned premium and the other is based, largely, on the estimate of the present value of future cash flows). Additionally, many have expressed their views that the separate presentation of the liability for remaining coverage and the liability for incurred claims provides decision useful information for analysis of non-life insurance contracts. The staff believes that separate presentation of the liability for remaining coverage and the liability for incurred claims would increase the transparency of an entity's financial statements, since separation of the performance obligation and the obligation to pay an amount in the statement of financial position would enhance a user's ability to assess the amount, timing, and uncertainty of the entity's future cash flows. The staff also believes that separate presentation of the liability for remaining coverage and the liability for incurred claims in the statement of financial position is consistent with separate presentation of the components in the statement of comprehensive income.

61. Other staff agree that, for those contracts measured under the premium allocation approach, the liability for remaining coverage should be disclosed separately from the liability for incurred claims but believe that disclosure in the notes would suffice.

62. In order to increase comparability across industries, the staff recommend that the rights to conditional premium should be presented in the statement of financial position netted against the liability for remaining coverage. The staff believe this proposed treatment of receivables and the liability for future coverage is consistent with the proposed revenue recognition model and financial instrument model (e.g., applied to derivatives).

Question 4 for the Boards:

For those contracts measured under the premium allocation approach:

(1) Do the Boards agree that the liability for remaining coverage should be disclosed separately from the liability for incurred claims?

(2) If the Boards agree to (1), should the liability for remaining coverage be presented separately from the liability for incurred claims in the statement of financial position?

Question 5 for the Boards:

Do the Boards agree that conditional rights to any premium measured under the premium allocation approach should be netted against the liability for remaining coverage, if presented separately from the liability for incurred claims?

The Level of Aggregation in the Statement of Financial Position

63. As noted in paragraph 23, many respondents stated that separate presentation of each portfolio on the face of the statement of financial position would result in an overly detailed and incomprehensible statement of financial position. The staff agree: the intention in the ED was that all portfolios in an asset position should be presented as one line item within assets and that all portfolios in a liability position should be presented as one line item within liabilities in the statement of financial position.

64. Although the staff do not support a requirement for aggregation and statement of financial position presentation of portfolios at a segment or a more granular level, the staff also considered the possibility of aggregation and presentation of insurance contracts on the basis of the measurement approach applied (i.e., separation of those measured under the building block approach and the premium allocation approach). As many respondents indicated, diversification

of risk is an essential aspect of an insurer's business model; and aggregation and presentation of insurance contracts at the portfolio level would not illustrate an insurer's diversification of risk in the statement of financial position. Under this proposal, the rights and obligations associated with insurance contracts would be presented in the statement of financial position in a manner that better reflects the way that an insurer manages its business.

65. This proposal would require an entity to aggregate and present all portfolios in an asset position and all portfolios in a liability position, segregated between those measured under the building block and premium allocation approaches.

66. If the Boards concur with the staff's recommendations to questions 4 and 5 of this paper, for portfolios measured under the premium allocation approach, any portfolios where the liability for remaining coverage exceeds the receivable for (conditional) premium would be aggregated and presented together, and any portfolios where the inverse holds true would be aggregated and presented together. It is expected that the separate liability for incurred claims will nearly always be a liability. As the insurance contract liability for contracts measured under the building block approach will include both of these components, aggregation of the liability for contracts measured under the building block approach with either of the liabilities under the premium allocation approach might detract from the goals of understandability and comparability.

67. As mentioned above, many users believe that the presentation of insurance contracts measured under the building block approach should be different from the presentation of insurance contracts measured under the premium allocation approach. One reason for this preference is that today analysts tend to focus on either life insurance or non-life insurance, and their analyses of each differ.

68. Indeed, key performance indicators for life insurance contracts differ from key performance indicators for non-life insurance contracts. The key performance indicators for life insurance contracts entail margin analysis for investments, mortality, morbidity, and actual-to-expected experience. In contrast, the key performance indicators for non-life insurance contracts involve the analysis of

combined loss ratios and claims development. It may thus be argued that separate presentation of insurance contracts measured under the building block approach (i.e., under the assumption that these are predominantly life insurance contracts) and insurance contracts measured under the premium allocation approach (i.e., under the assumption that these are predominantly non-life insurance contracts) would facilitate the analysis of these users.

69. Furthermore, the guidance in IAS 1 does not preclude the inclusion of additional line items at a greater level of detail in the statement of financial position. Thus, an entity may choose to present the rights and obligations associated with its insurance contracts at a lower level; and as noted in paragraph 55 of IAS 1, an entity "shall present additional line items, headings, and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial postion."

Staff Recommendation

70. The staff recommends that the liability (or asset) for insurance contracts should be presented separately for those measured using the building block approach and those measured using the premium allocation approach.

71. In the light of the obvious confusion that was created by the drafting, and because the respondents' views were consistent with the boards' intentions, we also recommend that we clarify that

    (a) portfolios that are in an asset position under each method may be aggregated in the statement of financial position, and

    (b) portfolios that are in a liability position under each method may be aggregated in the statement of financial position.

72. The staff believe this level of aggregation will balance faithful representation of an entity's financial position with operability considerations resulting from the proposed measurement of insurance contracts rights and obligations at a portfolio level. See Appendix A for an example of the staff's recommended presentation.

Question 6 for the Boards:

(a) Do the Boards agree that the liability (or asset) for insurance contracts should be presented separately for those measured using the building block approach and those measured using the premium allocation approach?

(b) Do the Boards agree that portfolios that are in an asset position should not be aggregated with portfolios that are in a liability position in the statement of financial position?

Appendix A – example of staff recommended presentation

Example 3: Assume that Best Insurer has two portfolios measured under the building block approach at 30 June 2011. Best Insurer has an expected loss ratio of 80%.

For the first portfolio, at 30 June 2011:

- The expected present value of Best Insurer's premiums receivable is 600 CU. Best Insurer's right to the premiums is conditioned on its provision of insurance protection (i.e., it does not have an unconditional right to any portion of the premium receivable at this point in time).
- The expected present value of Best Insurer's cash outflows to fulfill the insurance contract is 480 CU.
- The risk adjustment is 10 CU, and the remaining residual margin is 20 CU. The remaining single margin associated with the portfolio is 30 CU.

For the second portfolio at 30 June 2011:

- The expected present value of Best Insurer's premiums receivable is 600 CU. Best Insurer's right to premiums is conditioned on its provision of insurance protection (i.e., it does not have an unconditional right to any portion of the premium receivable at this point in time).
- The expected present value of Best Insurer's cash outflows to fulfill the insurance contract is 720 CU.
- The risk adjustment is 10 CU, and the remaining residual margin is 20 CU, and the single margin is 30 CU.

Assume that Best Insurer also has two portfolios (the third and fourth portfolios) on 30 June 2011 that provide one year of coverage and that are measured under the premium allocation approach. Best Insurer has an expected loss ratio of 80%.

For the third portfolio:

- The present value of Best Insurer's premiums receivable is 620 CU. Best Insurer's right to all but 20 CU of the premiums receivable is conditioned on its provision of insurance protection (i.e., Best has an unconditional right to 20 CU related to coverage already provided under its contracts but, it does not have an unconditional right to any other portion of the premium receivable in excess of 20 CU at this point in time).
- The present value of Best Insurer's liability for remaining coverage is 540 CU
- The present value of Best Insurer's liability for incurred claims is 480 CU.
- The risk adjustment is 10 CU.

For the fourth portfolio:

- The present value of Best Insurer's premiums receivable is 600 CU. Best Insurer's right to the premiums receivable is conditioned on its provision of insurance protection (i.e., it does not have an unconditional right to any portion of the premium receivable at this point in time).
- The present value of Best Insurer's liability for remaining coverage is 720 CU, and the present value of Best Insurer's liability for remaining incurred claims is 480 CU.
- The risk adjustment is 10 CU.

30 June 2011:

Assets			Liabilities and Stockholders' Equity		
Cash	1120	CU	Liability for Remaining Coverage – PAA	120	CU
Net Insurance Contract Asset – BBA (includes 30 CU single margin and YY effect of discounting)	90	CU	Net Insurance Contract Liability – BBA (includes 30 CU single margin and XX effect of discounting)	150	CU
Net Asset for Remaining Coverage - PAA	60	CU	Liability for Incurred Claims – PAA (includes ZZ effect of discounting)	980	CU
Unconditional Premium Receivable	20	CU	Retained Earnings	40	CU
Total Assets	1290	CU	Total Liabilities and Stockholders' Equity	1290	CU