STAFF PAPER

June 2012

REG FASB | IASB Meeting

Project	**Insurance contracts**		
Paper topic	Background to agenda paper 2C / FASB memo 84C		
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Introduction

1. At their October 2011 meeting, the boards tentatively decided that an insurer applying the building block approach should present premiums, claims, benefits, and the gross underwriting margin in the statement of comprehensive income. One board member suggested a method of deriving measures of 'earned premiums' from the liability measurement. The boards tentatively decided to give consideration to such a method, and asked the staff to develop it further for future consideration.

2. This paper provides background information to support agenda paper 2C/84C *Exploring a method of measuring earned* premiums, which explores in more detail the method of measuring earned premiums that was suggested at the October 2011 meeting. This paper recaps the decisions that the boards have reached to date and reminds you of other premium measures that could be presented in the statement of comprehensive income.

3. This paper does not contain any questions. Discussion questions are set out in agenda paper 2C/84C.

4. Future papers will address disclosures and transition.

Structure of paper

5. This paper includes

   (a) brief reminders of:

      (i) the proposals in the IASB exposure draft and FASB discussion paper (paragraphs 6-10);

      (ii) feedback received (paragraphs 11-13);

      (iii) subsequent board decisions (paragraphs 14-21);

   (b) a brief comparison of the key features of three possible measures of premiums previously discussed by the boards:

      (i) 'earned premium'—which measures the premiums received or receivable for services provided in the period, ie a measure that represents revenue for the period (paragraphs 23-29);

      (ii) 'written premium'[1]—which measures the expected present value of all the premiums receivable within the boundary of contracts initially recognised in the period. At the same time, the expected present value of all cash outflows over the life of the contact are presented as an expense, together with an expense arising from the initial recognition of the single margin (FASB) or of the risk adjustment and residual margin (IASB) (paragraphs 30-33).

      (iii) 'premium due'— in which premiums are presented as revenue when expected to be receivable and the corresponding increase in the liability is presented as an expense (paragraphs 34-37); and

[1] Written premium was defined in the FASB's DP as when receivable which is equivalent to the premiums due approach as defined above.

IASB exposure draft and FASB discussion paper proposals

IASB exposure draft proposals

6. The IASB's Exposure draft *Insurance Contracts* proposed that the presentation of income and expenses in the statement of comprehensive income should depend on the approach used to recognise and measure the insurance contract liabilities[2]:

   (a) *for contracts accounted for using the premium allocation approach,* the exposure draft proposed an earned premium presentation approach. An insurer would present in the statement of comprehensive income:

      (i) the underwriting margin—disaggregating this amount either in the statement of comprehensive income or in the notes into: premium revenue (the gross release of the obligation for remaining coverage on the basis of the passage of time or the expected timing of incurred claims and benefits), claims incurred, expenses incurred and amortisation of acquisition costs.

      (ii) changes in additional liabilities for onerous contracts.

   (b) *for contracts accounted for using the building block approach,* the exposure draft proposed a 'summarised margin' presentation approach. An insurer would separately present: the change in the risk margin, the release of the residual margin, experience adjustments, changes in estimates and accretion of interest on insurance contract liabilities in the statement of comprehensive income. The insurer would not disaggregate the underwriting margin to separately present premium revenue and claims etc.

7. The exposure draft proposed a summarised margin presentation approach for contracts accounted for using the building block approach on the grounds that:

   (a) such a presentation links clearly with the measurement approach for the insurance contract liability in the statement of financial position. Failure to illustrate such linkages is a significant defect of many existing models, particularly for long-duration contracts;

[2] IASB Exposure draft *Insurance Contracts* , July 2010, paragraphs 72-75.

(b) a summarised margin approach does not require the insurer to unbundle deposit receipts from the premiums because it treats premiums in the same way as deposits. Many longer-term life insurance contracts contain deposit components. Drawing a line between the deposits and the premiums may be somewhat arbitrary for some contracts.[3]

(c) information about premiums received and claims paid would be disclosed in the notes to the financial statements.

8. The basis for conclusions accompanying the exposure draft also discussed two 'premium' approaches for contracts accounted for using the building block approach: the 'premium due'[4] approach and the 'earned premium' approach.[5] However, the IASB rejected these premium presentation approaches on the grounds that:

(a) premiums are not necessarily receivable when the insurer provides its services. Consequently, a 'premium due' approach would be inconsistent with existing practices for recognising and presenting revenue for contracts other than insurance contracts, and with the proposed model in the exposure draft *Revenue from Contracts with Customers*.

(b) measuring earned premium is inherently challenging for some types of insurance contracts.

(c) premium approaches do not reflect changes in the building blocks that make up the measurement of the insurance contract. They do not provide the clear linkage between the statement of comprehensive income and statement of financial position.[6]

9. The exposure draft also discussed an approach that expands the summarised margin approach to provide information about premiums and claims (the 'expanded margin'

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3 Ibid. Basis for Conclusions, paragraph BC162.

4 The Exposure Draft labelled the 'premium due' approach as a 'written premium' approach. However, the term 'written premium' has since been applied to a different premium approach, ie one that measures the present value of the premiums expected to be receivable within the boundary of contracts initially recognised in the period. We therefore use the term 'premium due' throughout this paper to refer to the approach described in the Exposure Draft.

5 IASB Exposure draft *Insurance Contracts* , July 2010, basis for conclusions, paragraphs BC167.

6 Ibid. Paragraph BC168.

approach). In the expanded margin approach, the insurer presents in profit or loss both changes in the risk adjustment and the release of the residual margin during the reporting period, and some or all of the policyholder claims and benefits and other expenses. The IASB rejected this approach because, in some cases, the revenue recognised using the expanded margin approach would not be determinable directly, but would need to be imputed by 'grossing up' the change in margin by some or all of the claims and expenses[7]. Determining the amount presented in profit or loss could require significant costs (eg those associated with tracking historical information) and could result in amounts in profit or loss that cannot be related in a clear and understandable way to the amounts in the statement of financial position.

FASB discussion paper proposals

10. Most FASB members agreed with the IASB's proposal to require a summarised margin presentation for insurance contracts measured using the building block approach. However, the FASB was concerned about the proposal to require different presentation approaches for the building block approach and premium allocation approach. Consequently the FASB discussion paper illustrated three different presentation approaches (summarised margin, premium due and earned premium) and asked for feedback on them.

Feedback received from respondents

11. Feedback received on the exposure draft and discussion paper indicated that the summarized margin information was helpful but not useful enough on a standalone basis. Most respondents, including users, wanted the information supplemented by volume information regarding premiums, claims, and expenses. They argued that this information was too important to be limited to disclosure in the notes to the financial statements. Some respondents, whilst acknowledging that the summarized margin approach is conceptually sound for life contracts, thought that it does not provide the key performance indicators used to evaluate insurers.

[7] The amount presented in profit or loss could be based on estimated claims and expenses determined at inception of the contract, or based on the actual claims and expenses that occurred during the reporting period.

12. Premium approaches generally require a reconciling line item that "trues up" for changes in the insurance liability. Some respondents thought that the "true up" was meaningless and significantly reduced the quality of the performance statement while others thought that the volume information and related true-up were just as important to the performance of the underlying portfolio as the release of the margin. Most respondents who referred to the examples provided in the FASB's discussion paper preferred the premium due approach, mentioning the difficulties inherent in determining premium earned for certain life contracts measured under the building block approach.

13. Feedback was mixed regarding the proposal to present contracts accounted for using the building block approach separately from contracts accounted for using the premium allocation approach. Some respondents thought it would be desirable to present performance for all insurance contracts even if volume information was recognized on a different measurement basis. Others thought that requiring the separation of the information would improve the quality of information provided.

Subsequent discussions

14. The boards discussed presentation in the statement of comprehensive income during their February, March, June and October 2011 meetings.

15. At the March 2011 meeting, the board considered four possible approaches:

    (a) adding supplementary volume information to the statement of comprehensive income, but not presenting it as a component of income or expenditure;

    (b) an expanded margin approach with revenue recognised on a due basis;

    (c) a 'written premium' ("new business written") approach, whereby premiums would be measured at the expected present value of premiums receivable over the duration of new contracts written during the period.

    (d) a 'dual statement' approach in which insurers would present both a statement of comprehensive income in the traditional income statement format and a source of earnings statement which includes some of the components of the summarised margin approach. Both statements would arrive at the same net income result.

16. The boards did not make any decisions but directed the staff to seek input on these approaches from the Insurance Working Group and from other users of insurance financial statements to help the boards to understand which approaches are most likely to meet the needs of users and whether those approaches would cause practical difficulties for the preparers of the financial statements.

17. At the 15, June 2011 joint meeting, the staff reported the feedback it had received from the Insurance Working Group and users. The report is reproduced in the appendix to this paper.

18. The papers for the June meeting also further explored the three premium presentation approaches that the boards had discussed previously: earned premium, premium due and written premium[8]: The boards indicated a preference for:

    (a) a premium due presentation for the building block approach; and

    (b) an earned premium presentation for the premium allocation approach.

19. At their October 2011 meeting the boards discussed various ways of implementing this combination of approaches. In addition, the staff explored disaggregation of line items such that for each of premiums, benefits/claims and expenses, an insurer would present in the statement of comprehensive income both the expected and actual amounts, and the net of those two amounts. The boards tentatively decided that an insurer should present volume information (premiums, claims, benefits) and the gross underwriting margin in the statement of comprehensive income. However, they did not make any decisions on whether an insurer should combine the amounts for contracts measured using the building block approach with those for contracts measured using the premium allocation approach.

[8] Those presentation models are described in more details in agenda paper 3A/70A for the June 2011 meeting. It should be noted that ED/DP used term ‘premiums written’ similarly as agenda paper 3A/70A for the June 2011 meeting use for describing ‘premiums due’. In this paper we will use terms similar as in agenda paper 3A/70A for the June 2011 meeting rather than those described when developing ED/DP.

20. At that meeting, one board member suggested a method by which insurers applying the building block approach could derive a measure of 'earned premium' from the measure of the insurance contract liability. The boards tentatively decided to consider such a method further.

21. The method is considered further in agenda paper 2C/84C for this meeting.

Summary of three measures of premiums for presentation in the statement of comprehensive income

Introduction

22. This section provides a recap of the rationale, advantages and disadvantages of the three different premium measures—ie earned premium, premium due and premium written—that the boards have discussed at previous meetings. Appendix B provides an example which illustrates the differences between these approaches for a simple insurance contract. It is important to note that these approaches apply to the "remainder of the premium" after removing the portion of the premium associated with the investment component. The boards tentatively decided to exclude from the premium presented in the statement of comprehensive income amounts that the insurer is obligated to pay to the policyholder regardless of the occurrence of an insured event (ie disaggregate the investment component).

Earned premium

23. The objective of an earned premium approach is to provide a volume measure that is similar to the measure of revenue that results from applying the requirements proposed in the exposure draft *Revenue from Contracts with Customers* ('the draft Revenue standard'*)*. That exposure draft states that an entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. Applying similar reasoning to insurance, earned premiums are measured at an amount that reflects the consideration (premiums) to which the entity is entitled for the performance obligations that it has satisfied in the period, ie for the goods or services (insurance coverage) that it has transferred to the customer (policyholder) in the period.

24. The draft Revenue standard requires an entity to determine at contract inception whether the entity satisfies the performance obligation at a point in time or over time. We note that the draft revenue standard requires that an entity assess whether a performance obligation is satisfied at a point in time only if it fails the criteria for determining whether a performance obligation is satisfied over time. In an insurance contract, the performance obligation is the provision of coverage and, as discussed in agenda paper 2C/84C, an insurance contract typically satisfies the criteria in the draft Revenue standard for recognising revenue over time. While some may regard the insurance contract as being satisfied when the claims are incurred (ie at a point in time), the draft revenue standard does not envision a performance obligation as a promise to transfer cash or financial instruments (including transfers that occur on the occurrence of specified events). Performance obligations are promises to transfer goods and services to a customer. An insurance contract would be viewed as creating a performance obligation that requires the insurer to stand ready to pay valid claims, it would not be viewed as a financial instrument.

25. Applying the approach for recognising revenue over time, an insurer would recognise earned premiums over time by measuring the progress towards complete satisfaction of each performance obligation.

26. The result is that the premiums reported in each period reflect the amount the policyholder paid for the coverage provided in that period. For contracts where premium is paid in advance or where there are level premiums for the duration of the contract or a certain number of years (until deemed paid-up) an earned premium approach recognises premiums later than in a premiums receivable approach.

27. When the performance obligation is satisfied over time, the advantages of an earned premium presentation for contracts accounted for using the building block approach are that:

    (a) an insurer's statement of comprehensive income would present revenue information on a basis similar to that provided by entities in other industries under existing and proposed revenue recognition models.

(b) users of financial statements would be provided with useful information about the amount paid by the policyholder for the coverage provided during that period

(c) the presentation would be broadly consistent with that proposed for contracts accounted for using the premium allocation approach. The two amounts could be meaningfully compared or combined.

28. The main disadvantages of an earned premium presentation are that:

(a) measuring earned premiums is inherently challenging for some types of contract and those challenges can lead to operational complexity.

(b) Some users have expressed a preference for including volume information within the statement of comprehensive income. However, the volume information that is provided by an earned premium approach may differ from the information they currently use. In addition, some may be troubled by the result that because the probability of death increases over time, higher premiums would be recognised later in the contract than in the earlier years.

29. We explore the earned premium approach in more detail in agenda paper 2C/84C.

Written premium

30. The measurement model of the insurance contract liability requires estimating all the cash flows of the contract. The insurer measures a liability for the unbiased probability weighted estimate of expected cash flows, including those arising from the future contractual premiums and claims, plus a margin. Some believe that, given an insurer is required, at the time it writes the business, to recognise a liability representing the aggregate rights and obligations the insurer has accepted, the insurer should also recognise, at that time, corresponding premium reflective of the recognized rights and costs reflective of the recognized obligations (ignoring the investment component). This would result in no net impact on the statement of comprehensive income since the boards have tentatively decided that the difference between the present value of premiums received and expected and the present value of the expected cash out flow is recorded as a margin and the increase in the margin

would likewise be recorded as an expense in the statement of comprehensive income (eg, as a 'change in insurance liability – margin').

31. In the building block approach, any changes in the estimates of cash flows would be recorded to the statement of comprehensive income in the period when that change is determined. When the claim is incurred or paid out the statement of comprehensive income would not be impacted, except if the actual is different from the expected recorded at that time[9] or to the extent the event affects the measurement of the margin. Instead, the liability would be reduced as cash is paid and this would be apparent to users of the financial statements from the roll-forward of the liability which would require the insurer to disclose decreases from death claims paid, lapses/surrenders, etc.

32. Advantages to a written premium approach are that it:

    (a) Provides information about new business, such as premium written (which represents the level of new business written during the period) and claims expense (which represents the amount of obligation the insurer has accepted).

    (b) provides the clearest link to the building block measurement, using information already required under the proposals and therefore could be argued to be the least complex.

    (c) compares, at a single point in time, the (expected) consideration receivable from the customer for a period (namely the whole life of the contract) with the (expected) claims to be incurred for the same period.

33. Disadvantages of this model are that:

    (a) it results in the insurer recognising revenue when the insurer has not yet provided coverage, and recognising claims before those claims are incurred[10]. This is inconsistent with existing and proposed practices for

[9] Such a difference between actual and expected losses could also affect estimates of future cash flows. For example if more people died earlier than expected there will be an effect on future expected premiums and future expected claims.

[10] This approach would be least intuitive for recognizing revenue for contracts for which the premium allocation approach is applied.

recognising and presenting revenue for contracts other than insurance contracts.

(b) it is inconsistent with the premium allocation approach.

(c) there is uncertainty in whether or not the expected cash inflows (the premium) will be received. Therefore, recording the premiums based on written which are based on expectations of cash inflows that might not materialize could result in the recognition of premiums that are not received from the policyholder and future volatility in those amounts.

Premium due

34. The measurement model of the insurance contract liability is based on the present value of cash inflows less the present value of cash outflows. Some believe that the reduction in the present value of cash inflows (ignoring the investment component) resulting from cash receipts or the premiums becoming unconditionally due (and thus accounted for separately from the insurance contract liability and in accordance with existing guidance for receivables), should be recognized as premiums in the statement of comprehensive income. A corresponding expense would be recorded for the increase in the liability that results from this reduction of future cash inflows resulting in no net impact to the statement of comprehensive income and the full premium and benefits/claims and claims adjustment expenses would be recognized over time. Any differences in actual compared to expected claims costs would also be recorded in the statement of comprehensive income as an adjustment to claims expense.

35. Advantages of this approach are that:

(a) it provides volume information about premiums to which the insurer has an unconditional right and claims.

(b) The amount presented in the statement of comprehensive income is more certain than the total expected cash inflows that is included in the measurement of the liability and that would be recognised if using premiums written, while still giving information about the amount of new business in the period.

(c) It provides a link to the building block measurement, using information already required under the proposals (ie, the change in the future premium cash flows for existing contracts).

36. We also note that insurers commonly present premiums due in the statement of comprehensive income for life insurance contracts in many jurisdictions today. Many users of financial statements think that premiums due is useful in analysing insurance business.

37. Disadvantages of this approach is that:

(a) an insurer will have different gross results (premium “revenue” and claim expense) depending on the structure of the premium payment. For example, a single premium contract will result in revenue at inception of the contract and a recurring premium contract will result in revenue over time. Additionally, as in the written premium approach, the premiums due approach would result in the insurer recognizing revenue when the insurer has not yet performed (assuming receipt of premium before the corresponding performance, which typically occurs). That is inconsistent with existing and proposed revenue recognition models for other contracts with customers.

(b) Some believe this model is inconsistent with the premium allocation approach[11], which *is* consistent with proposed revenue models for other contracts with customers.

(c) Some believe that the way that claims and benefits are reported under this approach is difficult to understand.

[11] However, some staff note that for the majority of contracts accounted for under the premium allocation approach, the premium that is recognised is non-refundable and the insurer has an unconditional right to the consideration.

Appendix A

Additional feedback received from the Insurance Working Group and users of financial statements

A1. This appendix reproduces the report of feedback sought after the March 2011 meeting and reported to the boards in the papers for the June 2011 meeting.

Insurance Working Group

A2. Mixed feedback was received but some discussion applicable to the alternatives in [the March 2011 board papers] included:

(a) Premiums and claims are crucial to contracts with an insurance risk component

(b) New business written conveys useful information, particularly for the increased analytical benefit of distinguishing between previous and current period margin release. However, some feel it may not be appropriate for the performance statement

(c) Supplemental face disclosure is simple to understand

(d) Dual statements appear to provide an inferior statement for users less familiar with the industry

User Outreach

A3. Respondents included industry specialists and investment generalists representing buy-side, sell-side and credit rating organizations.

A4. Most users found the lack of volume information unacceptable. The outreach highlighted a strong resistance to an overhaul of the current [US] GAAP income statement. Some speculated that sensitivity to increased volatility and the summarized margin presentation would unintentionally reduce investor confidence in the industry.

A5. The complexities of the transactions and underlying accounting make the analysis inherently difficult. Removing commonly understood volume information from the face of the financial statement may unnecessarily exacerbate concerns over the tentative proposals especially in an industry with a relatively small number of specialists. Additionally, not providing volume information will accelerate the proliferation of non-GAAP measures in the industry and users will place less reliance on the GAAP financial statements.

A6. Some users provided specific feedback on the alternatives in [the March 2011 Board papers] including:

(a) Premiums, specifically information about the amount an insurer receives annually helps determine growth

(b) New business written information is very useful, but users indicated the alternative places too much focus on new business for the income statement

(c) Dual statements depicting performance may misrepresent information and cause confusion. This approach seemed counterproductive to the desire to provide volume information that improved the understanding of the new guidance.

(d) Source of earnings analysis requires close coordination within the industry that may not be achievable globally. However, the types of information provided in a source of earnings analysis can be useful

A7. Analysts referred to a variety of performance metrics they use in proprietary models that evaluate insurer performance. The statistical earnings supplement was regularly mentioned as an important source of information.

A8. Some users find statutory filings [of US insurers] helpful in evaluating claims development and investment exposure. This information is prepared on a premium due basis and considered useful. Significant drawbacks include distorted claims development tables (Schedule P) for multinationals applying inferior foreign currency translation methods and a time delay compared to general purpose financial reporting filings.

A9. Information about the earnings impact of new business was mentioned as a useful improvement to some current GAAP. An analysis of Embedded Value (common in Europe) and Source of Earnings (common in Canada) distinguishes this information from in-force contracts. However, some felt the assumptions underlying the measurement would unnecessarily distort the volume information appropriate for a financial statement.

Appendix B: Comparison of earned premium, written premium and premiums due

The following example shows a comparison of the three approaches discussed in this paper.

Assumptions:

- cash outflows equals claims incurred during the period
- no changes in future assumptions or experience adjustments
- expected cash flow and margin release pattern presented in the table below:

	Period 1	Period 2	Period 3	Total
Cash inflow pattern	420.0	400.0	380.0	1200.0
Cash outflow pattern	-200.0	-350.0	-500.0	-1050.0
Fulfilment cash flows	220.0	50.0	-120.0	150.0
Change in risk adjustment	32.0	30.0	28.0	90.0
Change in residual margin	23.0	19.0	18.0	60.0
Profit	**55.0**	**49.0**	**46.0**	**150.0**

Earned premium presentation

	Period 1	Period 2	Period 3	Total
Premiums earned	255.0	399.0	546.0	1200.0
Claims incurred	-200.0	-350.0	-500.0	-1050.0
Underwriting result	**55.0**	**49.0**	**46.0**	**150.0**

Reconciliation of underwriting result (disclosures)	Period 1	Period 2	Period 3	*Total*
Change in the risk adjustment	32.0	30.0	28.0	90.0
Change in the residual margin	23.0	19.0	18.0	60.0
	55.0	**49.0**	**46.0**	**150.0**

Premiums written presentation

	Recognition	Period 1	Period 2	Period 3	Total
Premiums written	1200.0	0	0.0	0.0	1200.0
Claims and benefits	-1050.0	0	0.0	0.0	-1050.0
Change in risk adjustment	-90.0	32.0	30.0	28.0	0.0
Change in residual margin	-60.0	23.0	19.0	18.0	0.0
Underwriting result	**0.0**	**55.0**	**49.0**	**46.0**	**150.0**

Premiums due presentation

	Period 1	Period 2	Period 3	Total
Premiums due	420.0	400.0	380.0	1200.0
Claims and benefits	-367.5	-350.0	-332.5	-1050.0
Change in risk adjustment				
Increase in risk adjustment	-31.5	-30.0	-28.5	-90.0
Release of risk adjustment	32.0	30.0	28.0	90.0
Change in residual margin				
Increase in residual margin	-21.0	-20.0	-19.0	-60.0
Release of residual margin	23.0	19.0	18.0	60.0
Underwriting result	**55.0**	**49.0**	**46.0**	**150.0**