STAFF PAPER

25-26 June 2012

Insurance working group

Project	**Insurance contracts**		
Paper topic	Presentation in the Statement of Comprehensive Income		
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Purpose of paper

1 This paper considers ways in which insurers applying the building block approach could present volume information (ie measures of premiums and claims) in the statement of comprehensive income. The paper compares three alternative measures of premiums: ‘earned premium’; ‘written premium’ and ‘premium due’. It asks for your views on:

(a) whether the information provided by an ‘earned premium’ presentation is useful (relative to the information provided by alternative presentations); and

(b) the operational feasibility of measuring earned premiums for contracts accounted for using the building block approach.

Structure of paper

2 This paper includes:

(a) background information in paragraphs 2-7 summarising:

(i) the proposals in the IASB exposure draft and FASB discussion paper;

(ii) feedback received, and

(iii) subsequent boards' tentative decisions.

(b) a brief comparison of the key features of three possible presentations containing different measures of premiums:

(i) 'earned premium'—which measures the premiums related to services provided in the period. This amount is similar to the 'revenue' reported in the financial statements of entities that sell non-insurance goods and services, and to the 'premium revenue' reported by insurers applying the premium allocation approach. Insurers would also present claims incurred in the period as an expense. (paragraphs 11-15);

(ii) 'written premium'—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 16-19); and

(iii) 'premium due'[1]— in which premiums are presented as revenue when expected to be receivable. Corresponding expenses (equal to (1) a portion of total expected outflows and single margin for FASB and (2) a portion of total expected outflows and risk and residual margin for IASB) are recognised at the same time, resulting in no impact in the statement of comprehensive income for the period (paragraphs 20-22).

[1] The 'premium due' measure was described as 'written premium' in the IASB exposure draft and FASB discussion paper. It has been re-named in this paper to distinguish it from the other measure now described as 'written premium'.

Background information

2. The IASB exposure draft proposed two different approaches for presenting income and expenses in the statement of comprehensive income:

   (a) for contracts accounted for using the premium allocation approach, it proposed a 'premiums earned' presentation. Insurers would separately present premium revenue, claims incurred, expenses incurred, amortisation of acquisition costs and changes in liabilities for onerous contracts.

   (b) for contracts accounted for using the building block approach, it proposed a 'summarised margin' presentation. Insurers would present the changes in the building blocks that make up the measurement of the insurance contract: the change in the risk adjustment, the release of residual margin, experience adjustments, changes in estimates etc.

3. For contracts accounted for using the building block approach, the exposure draft proposed the summarised margin, 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;

   (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.

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

4. Feedback received on the exposure draft and discussion paper indicated that the summarised 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. Furthermore, some are concerned about the comparability of a summarised margin presentation, not only within the insurance sector, but also with

other industries. Some respondents, whilst acknowledging that the summarised margin approach is conceptually sound for life contracts, thought that it does not provide key insight into the amount of new business written by insurers and the strain that this new business places on the resources of the insurer. In addition, while acknowledging that premium income is not equivalent to revenue in other industries, some users regard it as a proxy for revenue.

5. In response to this feedback, the IASB and FASB have been considering ways of presenting volume information in the statement of comprehensive income.

6. At their October 2011 meeting, the boards tentatively decided that an insurer applying the building block approach should present volume information in the statement of comprehensive income. However, they did not decide how insurers should measure the premiums.

7. At an education session in June 2012, the boards discussed a method of deriving measures of 'earned premiums' from the liability measurement. Board members expressed an interest in developing the method further, because it produces a measure of premiums that is similar to the revenue line reported by other industries. This would not be the case for other measures of premiums, such as 'premiums due' and 'written premium' measures. The boards also noted that they had tentatively decided to provide volume information in part because respondents had persuaded them that the summarised margin approach proposed in the ED would create an unjustifiable difference between the statements of comprehensive income presented by insurers compared to other industries. Accordingly, the boards agreed to explore further the usefulness of the information provided by an earned premium presentation and the extent of any operational difficulties. The first step would be to seek feedback from the Insurance Working Group.

8. Paper 10A explores in more detail the method of measuring earned premiums that the boards discussed in June 2012.

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

Introduction

9. This section provides a recap of the rationale, advantages and disadvantages of the three different premium measures—ie earned premium, written premium and premium due. The appendix provides an example which illustrates the differences between these approaches for a simple insurance contract.

10. Each of these presentations applies to the remainder of the premium after removing the portion associated with the investment component. The boards have 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

11. 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 recognise 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.

12. 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.

13. The result is that the premiums reported in each period reflect the amount for the service 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.

14. 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 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 and the two amounts could be meaningfully compared. Moreover, insurers could combine the results for contracts accounted for using the building block approach and premium allocation approach.

    (d) the presentation would be broadly consistent with the proposed revenue model for other contracts with customers. Thus it would address the concern expressed by many respondents to the ED that the summarised margin approach would not be comparable with other industries. Those respondents, including users of financial statements, noted that information about premiums is at least a proxy for turnover or revenue in other sectors.

15. The disadvantages are as follows:

    (a) it does not reflect changes in the building blocks that make up the measurement of the insurance contract. It does not provide the clear linkage between the statement of comprehensive income and statement of financial position that other presentations—in particular the summarised margin presentation and written premium presentation—provide.

    (b) it provides comparable information to that provided applying the draft Revenue standard only if the method used to measure earned premiums reflects the service provided over time and the value the policyholder receives. This measurement, which combines various drivers, can be difficult to determine consistently for varying types of insurance contracts.

(c) calculating earned premiums can be more challenging than calculating other premium measures, such as premium due or premium written. The method of calculating earned premiums explored in Paper 10A could overcome some of the difficulties. However, that paper shows that there could be operational challenges, even for quite simple contracts.

Written premium

16. The measurement model of the insurance contract liability requires insurers to estimate 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 recognised rights and costs reflective of the recognised 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').

17. When the claim is incurred or paid out there would be no effect on the statement of comprehensive income, unless the actual amount is different from the expected amount recorded at initial recognition. 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.

18. Advantages to a written premium presentation are that:

(a) it 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) it 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) it 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.

19. Disadvantages of this model are that:

(a) it results in the insurer recognising premiums when the insurer has not yet provided coverage, and recognising claims before those claims are incurred[2]. This is inconsistent with existing and proposed practices for recognising and presenting revenue for contracts other than insurance contracts.

(b) it is inconsistent with the presentation requirements for 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

20. 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 recognised as premiums in the statement of comprehensive income. Corresponding expenses (equal to a portion of total expected cash outflows and single margin for FASB or a portion of total expected

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

cash outflows and risk adjustment and residual margin for IASB) are recognised at the same time, resulting in no net impact to the statement of comprehensive income. Any differences in actual compared to expected claims would be recorded in the statement of comprehensive income as an adjustment to claims expense. 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.

21. 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.

22. Disadvantages of this approach are 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 recognising premiums before it has 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) it is inconsistent with the premium allocation approach and 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.

Questions for Working Group members

Questions
Do you think that the information provided by an earned premium presentation is useful? Do you think a requirement to measure earned premiums would be operationally feasible for insurers applying the building block approach? A possible method of measuring earned premiums is explored further in agenda paper 10A.

Appendix A: Comparison of earned premiums, written premiums 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**