IASB Agenda ref 2B

FASB Agenda ref 90B

15-18 October 2012

STAFF PAPER

REG FASB | IASB Meeting

Project	**Insurance contracts**
Paper topic	Presentation in statement of comprehensive income – non-claims fulfilment costs

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Purpose of paper

1. This paper explores an aspect of the earned premium presentation for the building block approach: the presentation of 'non-claims fulfilment costs'.

2. It considers:

   (a) *for the measurement of earned premiums:* whether and how a portion of the premium should be allocated to cover expected non-claims fulfilment costs; and

   (b) *for the measurement of claims and expenses:* when the non-claims fulfilment costs should be presented as expenses.

Staff recommendation

3. The staff recommend that, in an earned premium presentation:

   (a) a portion of the premium should be allocated to cover non-claims fulfilment costs. The amount so allocated should be equal to the originally expected non-claims fulfilment costs included in the measure of the building block liability;

   (b) the premium allocated to cover non-claims fulfilment costs should be included in insurance contract revenue in the periods in which the costs are expected to be released from the liability for remaining coverage, ie when it is expected that they will be either incurred or added to the liability for incurred claims; and

   (c) the amounts presented as expenses should be the actual costs incurred or added to the liability for incurred claims in the period.

4. The staff further recommend that any accompanying application guidance should acknowledge that in some circumstances, simpler procedures will produce results that are not materially different.

Scope of paper

What we mean by 'non-claims fulfilment costs'

5. The term 'non-claims fulfilment costs' is used in this paper to refer to the additional costs (on top of the expected claims and benefits) that an insurer expects to incur in fulfilling a portfolio of insurance contracts, and therefore includes in the measure of the building block liability. These costs include:

(a) policy administration and maintenance costs—these costs are the direct costs associated with maintaining the policies including the costs of premium billing, processing of premium collections and commissions, handling policy changes (eg conversions and reinstatements), and other costs of providing services to policyholders; and

(b) claim handling costs—the costs of processing and resolving claims under existing insurance contracts, including legal and adjuster's fees and internal costs of processing claim payments.

Existing accounting processes for non-claims fulfilment costs

6. The processes that insurers use at present to account for non-claims fulfilment costs provide some indication of the processes they might use to apply the building block approach.

7. Under existing accounting for insurance contracts in the U.S. and other jurisdictions, insurers account for non-claims fulfilment costs in a manner similar to that specified for the building block approach. Insurers include an estimate of the costs described in paragraph 5 in their liability for future policyholder benefits, although some insurers limit the included costs of providing traditional life insurance to only those costs that are non-level (i.e., do not vary directly with the premium). Insurers typically determine these non-claims fulfilment costs on a portfolio basis and convert these costs to a per-unit basis, with common units used including per policy and per face amount of coverage. Depending on the product line, the relative significance of expense categories, and the estimated pattern of these costs, insurers may or may not split the costs between policyholder administration and maintenance costs and claim handling costs. For example, contracts providing for disability income have higher claim handling costs than contracts providing only a death benefit and thus an insurer is more likely to split the costs amongst the two expense categories (assuming differing patterns of expected costs). The per unit factors (adjusted as appropriate for nonrecurring

expenses and major structural changes of an insurer) are applied to the projected number of policies that are expected to remain in force in the future or other units in estimating the expected cash outflows.

8. It is expected that insurers will replicate some of the processes described in the previous paragraph to estimate their insurance contracts liability and that the resulting data could be used to measure expenses presented in applying an earned premium model. Under existing accounting, insurers implicitly recognize in the statement of comprehensive income the estimated non-claims fulfilment costs associated with premiums due as part of the change in policyholder benefits reserve. Subsequently when the previously-estimated costs are incurred, these amounts are explicitly recognized as expenses and the related estimated expenses included previously in the change in policyholder benefits reserve are reversed. The recognition as expenses of these explicit costs would be comparable between existing practice and the earned premium presentation.

How this paper relates to the other premium presentation papers

9. The earned premium presentation aims to measure insurance contract revenue (premiums received and receivable for insurance coverage and other services) applying the principles in the draft standard *Revenue from Contracts with Customers* (the draft Revenue standard). It seeks to allocate the insurance contract revenue between periods in proportion to the price that the insurer would have charged for each period's coverage and other services if it had provided them for each period separately through a series of forward-start contracts.

10. The price that the insurer would have charged for coverage and other services in each period cannot be observed. However, applying the earned premium method developed in Agenda Paper 2A/90A *Presentation in Statement of Comprehensive Income—Comparison of Methods*, it can be estimated as the sum of:

    (a) the probability-weighted claims and benefits expected to be incurred as a result of that period's coverage;

    (b) the non-claims fulfilment costs that are expected to be incurred (at any time) as a result of providing that period's coverage and other services;

    (c) acquisition costs (as discussed in Agenda Paper 2C/90C for this meeting);

    (d) the risk adjustment relating to that period's coverage and other services (IASB only); and

    (e) the single or residual margin released in that period.

11. Items 10(a), 10(d) and 10(e) (the expected claims and benefits, risk adjustment and single or residual margin) are all components of the decrease in the liability for remaining coverage[1] that occurs as the insurer satisfies its obligation to provide coverage[2]. So they can be extracted from the movements in the liability for remaining coverage measured using the building block approach.

12. This paper discusses the item 10(b)—ie the non-claims fulfilment costs.

[1] The use of the term liability for remaining coverage in this paper refers to the net liability for remaining coverage (ie, gross liability minus gross premiums receivable).

[2] Under the FASB's building block approach model, the single margin isn't considered to be released from the "liability for remaining coverage" until it has been fully released from the aggregate insurance contracts liabilities (i.e., it isn't deemed to be reallocated to the liability for incurred claims whereas the remainder of the liability for remaining coverage will be released as of the last date a claim may be incurred under the contract).

Staff analysis and conclusions

13. This section considers:

    (a) whether a portion of the premium should be allocated to cover non-claims fulfilment costs (paragraph 15);

    (b) if so, how that portion of the premium should be allocated between periods (paragraphs 16-21);

    (c) when the non-claims fulfilment costs should be presented as expenses (paragraphs 22-24);

    (d) how the earned premium presentation should be specified to achieve the desired outcomes in (a)-(c) (paragraphs 25-26); and

    (e) how the boards could simplify the requirements (paragraph 27-30).

14. This section is followed by an example that illustrates the staff conclusions.

Should a portion of premium be allocated to non-claims fulfilment costs?

15. Yes – the staff think that, in calculating the insurance contract revenue (earned premiums) for each period, the insurer should include a portion of the total non-claims fulfilment costs because:

    (a) the insurer aims to cover these costs in the price it charges the policyholder, ie the actual price charged reflects these expected costs;

    (b) the costs are among the expected cash flows included in the measurement of the building block liability; and

(c) the earned premium presentation estimates the insurance contract revenue for each period as the sum of the components of the change in the liability for remaining coverage that occur as the insurer provides coverage. The calculation must include the expected non-claims fulfilment costs included in the measure of the liability or the total insurance contract revenue presented over the duration of the contracts will not equal the premiums received and receivable for the whole contract.

How should the premium allocated to non-claims fulfilment costs be allocated between periods?

16. The objective is to identify the price that the insurer would have charged for each period's coverage if it had provided coverage for each period separately through a series of forward-start contracts. To be consistent with this objective, the revenue allocated to the non-claims fulfilment costs each period should reflect the costs that the insurer would have expected to incur (at any time) if it had provided coverage for that period only.

17. The staff think that a reasonable estimate of these costs would be:

(a) *for costs associated with the provision of coverage and other services* (such as policy maintenance and administration costs)—the costs expected to be incurred in the period; and

(b) *for costs associated with the settlement of the claims liability* (such as claim handling costs)—the costs expected to be incurred in relation to *claims* expected to be incurred in the period.

18. The method of measuring earned premiums developed in Agenda Paper 2A/90A for this meeting allocates revenue associated with the service of standing ready based on the probability-weighted estimate of claims and benefits to be incurred in that period. Claim handling costs and other fulfilment costs associated with the settlement of claims are inherently dependent on the occurrence of a claim. Recognition in the statement of comprehensive income of the revenue associated with the expected claims handling costs on the same pattern as is to be used for revenue associated with the corresponding claims and benefits reflects this dependency.

19. In contrast to claims handling costs, many other non-claims fulfilment costs such as policy administration and maintenance costs are not directly dependent on the occurrence of a claim but instead are driven by other service obligations arising from the insurance contracts. Allocating the revenue based on the expected costs to be incurred in providing these services in the period is considered to be consistent with the principles of the revenue recognition standard and the basis behind the pattern for claims and claims handling expenses developed in Agenda Paper 2A/90A for this meeting.

20. Some may argue that writing the contract obligates the insurer to perform the policy administration and maintenance services as long as the insurance contract is in force consistent with the argument that an insurer has obligation to perform claims handling costs when the claim is incurred. However, some staff think that in the case of the policy administration and maintenance services, the event obligating the insurer to provide services is the contract remaining in force. Therefore the staff believe that it is appropriate to recognize these costs and the revenue related to these costs over the coverage period at the time the obligating event occurs and the services are provided. This is consistent with recognizing the claims handling costs when the obligating event to provide these services occurs, which is when the claims are incurred.

21. Other staff analyse the situation differently to get to the same conclusion. They think that the performance obligation to provide coverage (and any other services) arises when the contract is written. Revenue arises as this obligation is satisfied. The revenue is measured at the amounts released from the liability for remaining coverage as the services are provided. The amounts released include the expected costs of providing coverage (eg the expected policy administration and maintenance costs for that period of coverage) and the expected costs associated with the expected claims for the period (eg the expected claim handling costs).

When should non-claims fulfilment costs be reflected as expenses?

22. To be consistent with the way in which revenue is allocated to cover the *expected* non-claims fulfilment costs, *actual* non-claims fulfilment costs should be presented as expenses as follows:

    (a) the costs associated with the provision of coverage and other services should be presented as expenses when incurred[3];

    (b) the costs associated with the settlement of claims should be presented as expenses when the *claims* are incurred.

23. There are two ways of rationalising the requirement in paragraph 22(b). Some staff think that the insurer incurs a liability to pay claim handling costs when a claim is incurred. Others think that, although the insurer does not incur a liability to pay claim handling costs at that time (it does not incur the liability until the claim handling activity takes place), the insurer has incurred a liability to pay valid incurred claims, and the claim handling costs should be included in the measurement of that liability for incurred claims. Whichever rationale is applied, the claim handling costs are presented as an expense when the claims to which

[3] US GAAP ASC Topic 944 requires costs incurred during the period relating to investments, general administration and (indirect) policy maintenance to be charged to expense as incurred, However, specific direct maintenance costs are accrued as part of the benefit reserves.

they relate are incurred.[4] The expenses presented are an estimate at that time of the amounts that will eventually be payable. The estimates are updated from then until the claims are settled and all associated costs have been incurred.

24. In this way, an estimate of the actual costs is presented as an expense at the same time as an amount equal to the expected costs is included in revenue. Any difference in these amounts is the experience adjustment that, applying the building block approach, is recognised in profit or loss for the period. In the earned premium presentation the experience adjustment would not be a separate line item. Instead it would be embedded in the actual costs.

How would we specify the earned premium presentation to achieve these outcomes?

25. The boards would achieve the presentation outcomes described in paragraphs 15-24 by treating non-claims fulfilment costs in the same way as claims and benefits, that is:

    (a) *for the measurement of insurance contract revenue*: by presenting as revenue the *originally*[5] *expected* non-claims fulfilment costs released from the liability for remaining coverage as the insurer provides services throughout the coverage period;

    (b) *for the measurement of expenses*: by including the *actual* non-claims costs when they are incurred or added to the liability for incurred claims (and expenses); and

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4 US GAAP ASC Topic 944 requires a liability for all costs expected to be incurred in connection with the settlement of unpaid claims (i.e., claim adjustment expenses) to be accrued when the related liability for unpaid claims is accrued.

5 The 'originally expected' costs would exclude any later changes in estimates of the *amounts* of the costs that are recognised immediately in profit or loss (and hence presented separately in accordance with paragraph 25(c). The staff have not yet explored whether the original estimates should be updated for changes in the expected *pattern* of the future costs. The staff will consider this matter if the boards tentatively approve the earned premium presentation.

(c) *for changes in estimates of future costs:* by presenting changes in estimate that are recognised immediately in profit or loss[6], and the unwind of these changes in estimate, as a separate line item in the income statement.

26. The approach described in paragraphs 25(a) and 25(b) is illustrated later in this paper.

How could the boards simplify the requirements?

27. The approach described in paragraph 25 might be regarded as unduly complex for costs that are often a small proportion of the total contract costs. It could be argued that simpler approaches would typically produce similar results. For example, insurers need to find a premium recognition pattern to allocate a portion of premiums to cover estimated claims (i.e., the probability-weighted claims and benefits expected to be incurred as a result of that period's coverage), and they could apply the same pattern to the premium allocated to cover estimated non-claims fulfilment costs. Because these non-claims costs are often insignificant and the claims costs per period, as estimated at contract inception date, will often be reasonably stable (e.g., for a steady block of business), a premium recognition pattern driven by expected claims costs might often not differ materially from a pattern driven by expected incurred non-claims fulfilment costs. Similarly, the actual non-claims fulfilment costs could be recognized as expenses in the statement of comprehensive income when claims are recognized (e.g., determined based on the ratio of estimated non-claims fulfilment costs and the estimated claims costs). Accordingly, the liability for remaining coverage would be reduced and non-claims fulfilment costs deemed incurred based on the timing of expected and actual claims. Such a practical expedient would eliminate the need for insurers to determine both expectations regarding the timing of when non-claims

[6] For the FASB, this would be any change in estimate. For the IASB, it would be a change that results in contracts becoming onerous. (The change in estimate would first be offset against the residual margin, with only any amount in excess of the residual margin being recognised immediately in profit or loss.)

fulfilment costs are expected to be incurred and the timing of when they are actually incurred.

28. The boards could address concerns about complexity in two ways.

29. The first way would be to specify a practical expedient and circumstances in which insurers are permitted or required to apply that expedient. The boards might wish to constrain the use of the expedient to circumstances in which there is no evidence indicating that the results are likely to be significantly different from those produced by the approach described in paragraph 25. However, such circumstances might be difficult to define because several factors could be relevant, such as the amounts of the expenses, their nature (whether they are proportional to the number of contracts in force or the size of claims), and the degree to which the actual amounts can vary from the expected amounts.

30. An alternative way of addressing any potential concerns about complexity would be to acknowledge in application guidance that, in many situations, simpler approaches will produce results that are not materially different from those produced by the approach described in paragraph 25. Insurers would then be free to choose a method of simplifying procedures that works best for them. Although they would need to demonstrate that the results were not materially different, this might not be difficult if the non-fulfilment costs are relatively small and stable.

Illustrative example

Introductory comments

31. This example illustrates the mechanics of the presentation approach described in paragraph 25 and compares the results with those produced by a simpler method.

32. This example also illustrates another aspect of the earned premium method developed in Agenda Paper 2A/90A—the theoretical need to separate the building block liability into two components (the liability for remaining coverage and the liability for incurred claims). To illustrate this aspect of the method, the example assumes that claims are not paid until a year after they are incurred. However, in practice, the liability for incurred claims for life insurance contracts is often not material because claims are typically settled very quickly. For these contracts, the mechanics could be simpler than those illustrated in this example.

Fact pattern and assumptions

33. An insurer issues a portfolio of three-year contracts. To focus on the revenue and expenses associated with the non-claims fulfilment costs, this example assumes:

(a) claims are paid one year after they incurred;

(b) there are no acquisition costs and no investment component;

(c) the time value of money and risk are immaterial; and

(d) there is no single or residual margin.

34. The expected cash flows are shown in Table 1.

Table 1: Expected cash flows

Cash flow	Year 1	Year 2	Year 3	Year 4	Total
Premium received	1,000	1,000	712	-	2,712
Claims paid (having been incurred in previous year)	-	(700)	(800)	(900)	(2,400)
Contract maintenance costs	(24)	(24)	(24)	-	(72)
Claim handling costs (paid at same time as claims)		(70)	(80)	(90)	(240)
Net cash inflows/ (outflows)	976	206	(192)	(990)	-

Measurement of insurance contract revenue for each period

35. The insurance contract revenue (earned premium) for the period is estimated as the sum of the amounts released from the liability for remaining coverage as the insurer satisfies its obligation to provide coverage. The changes in the liability for remaining coverage are shown in Table 2 below.

Table 2: Changes in liability for remaining coverage

	Year 1		Year 2		Year 3	
Liability at start of period		-		206		302
Premium received (Table 1)		1,000		1,000		712
Amounts released as insurer satisfies performance obligations (Table 1):						
- Expected contract maintenance expenses	(24)		(24)		(24)	
- Expected claims*	(700)		(800)		(900)	
- Associated claim handling costs*	(70)		(80)		(90)	
- **Insurance contract revenue**		(794)		(904)		(1,014)
Liability for remaining coverage at end of period		206		302		-

* The actual claims and actual associated claim handling costs are added to the liability for incurred claims.

36. However, as claims are incurred there are also changes in the liability for incurred claims. These change are shown in Table 3.

Table 3: Changes in liability for incurred claims

	Year 1	Year 2	Year 3	Year 4
Liability for incurred claims at start of period	**-**	**770**	**880**	**990**
Claims incurred	700	800	900	-
Associated claim handling costs	70	80	90	-
Claims settled one year later	-	(700)	(800)	(900)
Claim handling costs settled at same time	-	(70)	(80)	(90)
Liability for incurred claims at end of period	**770**	**880**	**990**	**-**
Total Insurance contracts liability	**976**	**1,182**	**990**	**-**

Measurement of expenses for each period

38. The non-claims fulfilment costs presented as expenses for the period are:

(a) the estimated claim handling costs associated with claims incurred in the period. These are the amounts added to the liability for incurred claims in Table 3; and

(b) the contract maintenance costs for the period.

Table 4: Expenses presented in statement of comprehensive income

Non-claims fulfilment costs	Year 1	Year 2	Year 3	Year 4	Total
Claim handling costs added to liability for incurred claims (Table 3)	70	80	90	-	240
Contract administration and maintenance costs incurred in period (Table 1)	24	24	24	-	72
	94	104	114	-	312

Statement of total comprehensive income

39. The insurance contract revenue, claims and expenses are presented in the statement of total comprehensive income as shown in Table 5 below.

Table 5: Statement of comprehensive income – earned premium presentation

	Year 1	Year 2	Year 3	Year 4	Total[7]
Insurance contract revenue (Table 2)	794	904	1,014	-	2,712
Claims (Table 3)	(700)	(800)	(900)	-	(2,400)
Expenses (Table 4)	(94)	(104)	(114)	-	(312)
Gross underwriting margin	-	-	-	-	-

[7] The 'Total' column is included to aid understanding of the example. It would not be presented as part of an insurer's statement of comprehensive income.

Simplifications in practice

40. In this example, a simpler approach to the treatment of non-claims fulfilment costs would have resulted in very similar measures of expenses and revenue.

41. The total expected costs of 312 (72 + 240, Table 1) represent 13% of the total expected claims of 2,400 (Table 1). Given that the insurer has not revised its estimates of the total non-claims fulfilment costs, suppose the insurer had simply measured its non-claims fulfilment costs for the period as 13% of actual claims incurred. The resulting amounts presented as revenue and expenses are set out in Table 6.

Table 6: Expenses and revenue estimated as a percentage of claims

	Year 1	Year 2	Year 3	Year 4	Total
Expenses					
Expenses presented applying the approach illustrated in this example (Table 5)	94	104	114	-	312
Expenses estimated as 13% of actual claims incurred (Table 5)	(91)	(104)	(117)	-	(312)
Difference	3	-	(3)	-	-
Total insurance contract revenue presented applying the approach illustrated in this example (Table 5)	794	904	1,014	-	2,712
Revenue measured if attributing 13% of claims incurred to non-claims fulfilment costs[8]	791	904	1,017	-	2,712
Difference	3	-	(3)	-	-

8 Calculated by deducting from the total insurance contract revenue (Table 5) the revenue arising from the non-claims fulfilment costs (Table 3) and adding the expenses estimated as 13% of actual claims incurred (Table 6).

Comparison with premium due and written premium presentation

42. The appendix to this paper shows how the contracts illustrated in this paper would be presented applying a premium due presentation or written premium presentation. The amounts presented as claims and expenses would not be the amounts incurred in the period. They would be:

(a) *in the written premium presentation,* the total amounts expected to be incurred in current and future periods for contracts written in the period;

(b) *in the premium due presentation,* a portion of the total amounts expected to be incurred in current and future periods, calculated by applying the expected expense ratio to the premiums due in the period.

Summary of staff conclusions and recommendations

43. The main conclusions of this paper are that, in an earned premium presentation:

(a) a portion of the premium should be allocated to cover non-claims fulfilment costs. The amount so allocated should be equal to the originally expected non-claims fulfilment costs included in the measure of the building block liability;

(b) the premium allocated to cover non-claims fulfilment costs should be included in insurance contract revenue in the periods in which these costs are expected to be released from the liability for remaining coverage, ie when it is expected that they will be either incurred or added to the liability for incurred claims; and

(c) the amounts presented as expenses should be the *actual* costs incurred or added to the liability for incurred claims in the period.

44. Given that such an approach might be complex in some circumstances, the staff think that it would be helpful if the boards acknowledge that in some circumstances simpler procedures will produce results that are not materially different.

45. The staff do not recommend a specifying a particular practical expedient because:

(a) it could be difficult to define the circumstances in which the a practical expedient is likely to produce results that are not materially different from those produced by the approach described in paragraph 43; and

(b) insurers should be free to choose a method of simplifying procedures that works best for them. Although they would need to demonstrate that the results were not materially different from those produced applying the approach described in paragraph 43, this might not be difficult if the non-fulfilment costs are relatively small and stable.

Questions for the Board

Question 1: Requirements of earned premium presentation
Do you agree that in an earned premium presentation: (a) a portion of the premium should be allocated to cover non-claims fulfilment costs. The amount so allocated should be equal to the originally expected non-claims fulfilment costs included in the measure of the building block liability; (b) the premium allocated to cover non-claims fulfilment costs should be included in insurance contract revenue in the periods in which the costs are expected to be released from the liability for remaining coverage, ie when it is expected that they will be either incurred or added to the liability for incurred claims; and (c) the amounts presented as expenses should be the actual costs incurred or added to the liability for incurred claims in the period?

Question 2 on next page →

Question 2: Simplification

Do you agree that any accompanying application guidance should acknowledge that in some circumstances, simpler procedures will produce results that are not materially different?

Appendix: Premium due and written premium presentations

A1. This appendix shows how the contracts illustrated in this paper would be presented applying a premium due presentation (Table 8) or written premium presentation (Table 9).

A2. For the premium due presentation, expenses are recognized in the statement of comprehensive income when the premium is recognized in the statement of comprehensive income (i.e., when due). Thus, whereas, under the earned premium approach the costs drive the revenue recognition, under the premium due (and written) presentations the revenue recognition drives the cost recognition. Accordingly, under the premium due presentation if the claims and other expenses are to be disaggregated, it is necessary to estimate the expected loss ratio and expected expense ratio for the contracts. This ratio is applied to the premiums due in each period to measure the claims and expenses presented in that period.

Table 7: Expected claim and expense ratios

	Total expected cash flows Table 1	% of premiums	
Premiums	2,712		
Claims	(2,400)	88.5%	Expected claim ratio
Contract maintenance costs	(72)	11.5%	Expected expense ratio
Claim handling costs	(240)		
Net cash inflows	0	0%	Underwriting margin

Table 8: Statement of comprehensive income – premium due presentation

	Year 1	Year 2	Year 3	Total
Premium due (Table 1)	1,000	1,000	712	2,712
Claims (88.5% claim ratio, Table 7)	(885)	(885)	(630)	(2,400)
Expenses (11.5% expense ratio, Table 7)[9]	(115)	(115)	(82)	(312)
Gross underwriting margin	-	-	-	-

Table 9: Statement of comprehensive income – written premium presentation

	Year 1	Year 2	Year 3	Year 4	Total
Premium written (Total expected, Table 1)	2,712	-	-	-	2,712
Claims	(2,400)	-	-	-	(2,420)
Expenses (Total expected, Table 1)	(312)	-	-	-	(312)
Gross underwriting margin	-	-	-	-	-

9 In practice insurers will need to track in their general ledgers the various functional costs (e.g., for payroll tax purposes, to support some reinsurance recoveries, etc.). Accordingly, the costs are accrued initially as part of the insurance contracts liability with a corresponding debit to the statement of comprehensive income as shown in this example. Separately, the insurer will also record the “expense” to a functional cost line in the general ledger when they are actually incurred (or paid). This “expense” will be offset by a change in the insurance contracts liability thus being neutral to net income (assuming no experience adjustment). Thus, in the premium due and written models, insurers essentially accrue for the expenses that the insurer is obligated for based on the amount of premiums that were recognized.