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Project	Insurance contracts
Paper topic	Considering the transition proposals in the light of subsequent decisions on insurance contracts revenue

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Purpose of this paper

1. In September 2012, the Boards tentatively decided how to measure the insurance contracts liability on transition to the proposed Standard. In October 2012, the Boards tentatively decided that for insurance contracts accounted for using the building block approach, an insurer should present insurance contracts revenue based on the assumptions used in determining the liability for remaining coverage (a component of the insurance contracts liability).

2. This paper discusses determining, for contracts in force as of the transition date, the amount of premium that will be earned in the future under the proposed guidance.

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The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

Staff recommendation

3. Both the IASB and FASB staff believe that, on transition, insurers should determine the part of the liability for remaining coverage that is used to determine the amount of the revenue to be recognised in the statement of comprehensive income after transition. However, because of the previous tentative decisions reached by the IASB and FASB, the staff reached different recommendations.

4. The IASB staff is recommending that in order to estimate the amount of the revenue to be recognised in future periods, the insurer should estimate the residual margin or loss included in the liability for remaining coverage on transition through modified retrospective application of the Standard. Consequently, the IASB staff is recommending:

   (a) That the IASB modify the retrospective application of the Standard as follows: in determining the residual margin through retrospective application of the Standard, an insurer should assume that all changes in estimates of the risk adjustment between initial recognition and the beginning of the earliest period presented were already known at the date the contract would have been initially recognised. This would mean that the risk adjustment at inception is assumed to equal the risk adjustment on transition.

   (b) Additionally, if retrospective application is impracticable, an insurer should estimate the residual margin at the beginning of the earliest period presented maximising the use of objective data. (In other words, an insurer should not calibrate the residual margin to the insurance liability measured using previous GAAP.[1])

[1] The staff notes that this recommendation would partially reverse a previous tentative joint decision that if retrospective application of the Standard is impracticable, an insurer should calibrate the residual margin at transition to the carrying amount of the liability using previous GAAP (please refer to the summary of the decisions in paragraph 6).

5. The FASB staff is recommending that:

   (a) For contracts for which the margin is determined through retrospective application, the insurance contract revenue remaining to be earned as of the date of transition should be determined retrospectively utilizing the assumptions applied in the retrospective determination of the margin.

   (b) For contracts for which retrospective application is impracticable because it would require significant estimates that are not based solely on objective information, the remaining insurance contract revenue to be earned should be presumed to equal the amount of the liability for remaining coverage (excluding any investment components) recorded at the date of transition (plus accretion of interest).

      (i) The liability for remaining coverage for these contracts at the date of transition should be presumed not to consist of any losses on initial recognition or changes in estimate of future cash flows recognised in profit or loss after the inception of the contracts.

      (ii) The remaining insurance contract revenue to be earned shall be limited to the total expected cumulative consideration for in-force policies in the portfolio (plus interest accretion and less investment component receipts).

      (iii) The remaining insurance contract revenue should be allocated to periods subsequent to the date of transition in proportion to the value of coverage (and any other services) that the insurer has provided for the period (ie. applying the pattern of expected claims and expenses and release of margin).

Background

Previous tentative decisions about transition

6. At their September 2012 meetings, the Boards discussed transition for the proposed insurance contracts standard. Those discussions focused on balances

presented in the statement of financial position. The Boards tentatively decided that when an insurer first applies the proposed standard, the insurer should, at the beginning of the earliest period presented:

(a) measure the present value of the fulfilment cash flows using current estimates at the date of transition (ie as of the earliest period presented); and

(b) determine the single or residual margin through retrospective application of the new accounting principle to all prior periods. However,

   (i) For contracts issued in earlier periods for which retrospective application would normally be considered impracticable because it would require significant estimates that are not based solely on objective information, an insurer should estimate what the margin would have been if the insurer had been able to apply the new Standard retrospectively. In such cases, an insurer need not undertake exhaustive efforts to obtain objective information but should take into account all objective information that is reasonably available.

   (ii) If it is impracticable to apply the new accounting policies retrospectively for other reasons, an insurer should apply the general requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* / FASB ASC Subtopic 250-10 *Accounting Changes and Error Corrections—Overall* that are relevant to situations in which there are limitations on retrospective application (ie measuring the margin by reference to the carrying value before transition).

7. Additionally, in October 2012, the IASB tentatively decided to add practical expedients for retrospective application of the Standard, specifically, that an insurer should determine the residual margin on transition assuming that all

changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition.

8. At its May 2012 and October 2012 meeting, the Boards tentatively decided that, in the statement of comprehensive income, an entity should:
   (a) present revenue over the coverage period as the entity satisfies its obligations arising from insurance contracts (in proportion to the value of coverage and any other services provided[2]);
   (b) present claims and other expenses on an incurred basis;
   (c) if an insurance contract requires the entity to repay amounts to policyholders or their beneficiaries regardless of whether an insured event occurs:
      (i) exclude from revenue the amounts that had been received from the policyholder for such repayments.
      (ii) exclude those repayments from the claims incurred.

Explaining the issue

9. As noted in paragraph 8, an insurer would be required to present revenue and expenses in the statement of comprehensive income for reporting periods on or after the effective date and for all comparative periods presented. An entity will use assumptions used in the measurement of a component of the insurance contract liability to estimate the amount of the revenue recognised in the statement of comprehensive income each period (eg by reference to specific changes in the building block liability). Similar to the measurement of contracts under the premium allocation approach, the insurance contracts liability under the building blocks approach might be thought of as including a liability for incurred claims and a liability for remaining coverage. The liability for remaining coverage component can be used to estimate the revenue. Consequently, the insurer needs

[2] The entity measures its revenue by reference to specific changes in the building block liability.

to identify separately the following components of the liability for remaining coverage[3]:

(a) The liability for remaining coverage excluding any amounts attributable to losses on initial recognition or to subsequent changes in estimates of claims, benefits and expenses recognised immediately in profit or loss. This liability is used as a measure of progress in satisfying the obligation to provide coverage. Consequently, the reduction in this liability would be recognised as revenue in the statement of comprehensive income[4] (subject to excluding the part related to any repayments of investment components); and

(b) The liability for remaining coverage attributable to (i) losses on initial recognition and (ii) subsequent changes in estimates of claims, benefits and expenses recognised immediately in profit or loss (to the extent not yet reversed in the statement of comprehensive income as claims were incurred[5]). Changes in this liability would not be presented as part of the revenue amount.

10. By estimating separately the components of the liability for remaining coverage as stated above, the insurer would avoid recognising more revenue than the total consideration charged to the policyholder plus accreted interest. However, because of previous tentative decisions related to unlocking the residual margin, the amount of the liability for remaining coverage attributable to (i) losses on initial recognition and (ii) subsequent changes in estimates of claims, benefits and expenses recognised immediately in profit or loss would be different for the IASB and FASB, as follows:

[3] The measurement of the revenue is described in more details in agenda paper 2A/90A for the October 2012 meeting.

[4] The revenue recognised based on the movement of the liability for remaining coverage would exclude certain changes in this liability, especially those that arise from the expectation of receipts of premiums.

[5] As described in more detail in agenda paper 2A/96A, changes in estimates of the amount of future incurred benefits (to the extent not directly offset by changes in the residual margin) and any losses recognised at contract inception are reversed when the related claims are incurred (ie so as not to double count the expense).

(a) for the IASB, it will be the cumulative amount of changes in cash flows when the residual margin is exhausted; and

(b) for the FASB, it would be related to any changes in cash flows recognised in the statement of comprehensive income.

11. As noted in paragraph 7, the IASB decided that, on transition, changes in estimates of cash flows before the beginning of the first period presented would be treated as having been known at initial recognition. As a result of that decision any changes in estimates that occurred before transition would adjust the residual margin (or loss) estimate at inception rather than prospectively from the date the insurer knew about them.

12. As a result of different tentative decisions taken by the boards related to transition (as noted in the paragraphs above), the staff performed a separate analysis for the IASB and FASB because of different considerations taken into account.

(a) The IASB analysis and recommendation is included in paragraphs 13-19.

(b) The FASB analysis and recommendation is included in paragraphs 20-32.

Staff analysis – IASB section

13. The staff believe that it is important that an insurer would not present more revenue than premiums received (excluding investment component receipts) plus interest. To avoid presenting more revenue than premiums received, the insurer would need to estimate the cumulative amount of changes in cash flows that would have exhausted the residual margin before the earliest period presented. Furthermore, to estimate those cumulative changes, the insurer would need to apply the Standard retrospectively to estimate the gain (residual margin) or loss at inception. However, to estimate the loss or gain at inception, the insurer would need to estimate the amounts at inception related to the following:

(a) the expected amount of the cash flows – with the simplification related to treatment of all changes from inception until the earliest period presented as known at inception;

(b) the discounting effect – with the simplifications related to estimating the locked-in discount rate at inception as tentatively decided by the Boards at their October 2012 meeting; and

(c) the risk adjustment:

(i) the staff believe that estimating the risk adjustment at inception could be very complicated. Because the risk adjustment is based on entity specific inputs, it would be very difficult to estimate without hindsight, which would, in any case, reduce comparability. Additionally, estimating a risk adjustment in prior periods could be compared to estimating fair value in prior periods, which the IASB had previously decided is not practicable.

(ii) some might also argue that the risk adjustment should be estimated by reference to the cash flows distribution, and therefore the estimate of risk should be adjusted as a consequence of the tentative decision related to treatment of changes in cash flows.

14. On the grounds that estimating the amount of the risk adjustment at inception could be impracticable for most contracts, the staff believe that the insurer should assume that all changes in the risk adjustment that occurred before transition were known at inception. This would mean that the insurer would assume the risk adjustment at inception would have equalled the risk adjustment on transition. This is because the cash flows between inception and transition were known (consistently with the presumption that there were no changes related to cash flows before transition). Consequently, the insurer would assume:

(a) the expected cash flows at the date of transition are risk-adjusted using the risk adjustment as calculated at the transition date; and

(b) the cash flows that occurred before the date of transition were known and there was no risk adjustment for those cash flows.

15. This simplification would have the following advantages:

(a) The insurer would not need to make a separate estimation of the risk adjustment at inception.

(b) It is consistent with the simplification that the IASB tentatively decided upon in relation to changes in estimates of cash flows (if the insurer assumes that it knew at inception about all changes that occurred prior to transition, then the risk associated with those changes in cash flows would equal zero).

16. Applying this simplification, however, would mean that the residual margin and revenue recognised after transition for contracts in force at the date of transition might not be comparable with analogous amounts for contracts written after transition. This is due to the fact that for contracts written before transition, the residual margin and revenue would be recognised based on assumptions related to the risk adjustment that are different from the assumptions at inception. The difference between those assumptions would result in a residual margin (gain) or loss recognised at inception and, if applicable, subsequent changes in the residual margin.

17. As a further consequence, the staff believes that with the simplifications proposed in relation to the risk adjustment estimation and changes in cash flows, there should be no circumstances when an insurer would not be able to estimate the residual margin retrospectively on transition maximising the use of objective information[6]. The insurer could use either method below to achieve the same result when estimating the residual margin (or loss on initial recognition):

[6] Please refer to paragraph 6(b), which describes tentative decisions related to measurement of the residual margin on transition.

(a) at inception, by comparing the expected present value of the future cash outflows with the present value of future cash inflows at inception, adjusted for risk; or

(b) on transition, by comparing the present value of expected cash outflows, adjusted for risk, with the amount of total expected (and received) premiums plus interest adjusted for the release.

18. Therefore, the staff believes that these simplifications mean that there are no circumstances in which it would be necessary to measure the insurance liability according to previous GAAP. The staff also observes that the IASB's previous decision to calibrate the residual margin to previous GAAP:

(a) would result in inconsistent accounting for contracts for which the residual margin is estimated in this way and those for which the residual margin is estimated retrospectively.

(b) may introduce a need to apply a constraint on the amount of residual margin recognised at the date of transition, which would add additional complexity to the transition requirements.

(c) would not allow insurers to estimate appropriately the amount of revenue to be recognised after transition because the amount of the residual margin within the liability was not estimated using retrospective application of the Standard.

19. Consequently, the staff also recommends that an insurer should always be required to estimate the residual margin as described in paragraph 17 and should not be required to calibrate the residual margin to the insurance liability recorded under previous GAAP.

Question 1: Additional requirements for transition

Does the IASB agree that:

a. in determining the residual margin through retrospective application of the new standard, an insurer shall assume that all changes in estimates of the risk adjustment between initial recognition and the beginning of the earliest period presented were already known at the date the contract would have been initially recognised. This would mean that the risk adjustment at inception is assumed to equal the risk adjustment on transition; and consequently that

b. when retrospective application is impracticable, an insurer shall estimate the residual margin maximising the use of objective data (ie that an insurer should not calibrate the residual margin to the insurance liability measured using previous GAAP)?

Staff analysis – FASB section

20. As noted in paragraph 6(b), the boards tentatively decided that insurance contracts would be measured using retrospective application for the Standard where it is practicable. Where it is not practicable to apply the Standard retrospectively:

    (a) because it would require significant estimates, the insurer would estimate the margin maximising the use of the objective information available; or

    (b) for other reasons than in (a), an insurer should apply the general requirements of FASB ASC Subtopic 250-10 that are relevant to situations in which there are limitations on retrospective application (that is, measure the margin by reference to the carrying value before transition).

21. As noted in paragraph 9, in order to estimate the amount of the liability for remaining coverage component of the insurance contracts liability, which would be used as a measure for determining the revenue post transition, the insurer

would need to separately identify the amount of the liability related to changes in assumptions between inception of the contracts and the earliest period presented and, if there were any losses on initial recognition, the portion of these losses that remains to be reversed. The staff believe that for the contracts where retrospective application was applied to estimate the single margin, the insurer should have the data to objectively determine these amounts.

22. However, when retrospective application was not applied because it was impracticable, the insurer would likely not have data to estimate how much of the liability for remaining coverage is related to changes in assumptions. To determine how much of the liability is related to changes in assumptions and day 1 losses, the staff believe an insurer would need to determine the contracts' inception date estimates of the amount and timing of the (then) future cash flows, which would suggest that the insurer would have been able to determine the initial margin retrospectively.

23. The example below illustrates how the amount of revenue would be affected by the determination of how much of the liability for remaining coverage is related to changes in estimates of future claims.

Example 1

Assumptions:

- Insurer has an existing portfolio of single premium insurance contracts with CU 1000 of premium received and CU 500 of benefits incurred and paid in advance of the transition date;
- The insurer concluded it was impracticable to determine the single margin retrospectively, but the insurer estimated the margin would have been CU 100 if it had been able to apply the new standard retrospectively;
- At the date of transition the insurer estimated the remaining benefit payments and margin to be CU 450 and CU 50, respectively;
- For simplicity, this example assumes a 0% discount rate.

Based on the above information, the insurer would be able to estimate the original assumption of claims to be incurred as follows:

Premiums received	CU 1000
- Estimated initial margin	(CU 100)
= Original assumption of claims to be incurred	CU 900

And the previous changes in estimates of future incurred claims as follows:

Estimated future incurred claims	CU 450
+ Claims incurred to date	CU 500
= Current estimate of claims	CU 950
- Original assumption of claims to be incurred	(CU 900)
= Changes in estimates of future incurred claims	CU 50

How much of the insurance contract liability represents revenue to be recognised in the statement of comprehensive income after transition?

The answer lies in how much of the CU 50 is deemed to have been reversed prior to transition and how much remains at the date of transition. Had the additional CU 50 of claims been incurred prior to the transition date, upon the occurrence of those claims the previous change in estimates of future incurred claims would have been reversed and the full CU 450 (plus CU 50 or remaining margin) should be earned as revenue subsequent to the transition date. On the other extreme if the additional CU 50 of estimated claims relates to claims expected to be incurred after the effective date, then the future revenue should be CU 50 lower.

24. In the above example if the insurer were able to apply the proposed insurance contracts standard retrospectively, it would have had estimates of the timing of when each of the estimated claims would be incurred. Furthermore, it would have been able to attribute the change in estimates of future incurred claims to specific periods and been able to reverse those estimates in those periods when the related claims were incurred. Consequently, if each of these pieces of information were known it would seem likely to be practicable (and thus required) to apply the standard retrospectively.

25. However, as discussed in Agenda paper 2B / 89B for the September 2012 joint meeting, the staff anticipate that, where it is not practicable to determine the margin through retrospective application of the model, the margin might instead

be estimated by using an estimate of the expected profit based on historical assumptions of expected premiums and the ROE for contracts written during the time period. Such methods would often not facilitate the determination of how much of any past changes in estimates of future benefits and expenses related to which periods.

26. Consequently, the staff believe that, for portfolios for which the margin is not determined through retrospective application of the proposed standard, a practical expedient should be applied for purposes of estimating the amount of remaining insurance contracts revenue to be recognised subsequent to the transition date.

27. The staff considered two alternatives. One such alternative would be that, for those contracts, the whole liability for remaining coverage (ie the insurance contracts liability excluding components representing the liability for incurred claims and the gross amount of premiums receivable[7]), excluding any investment component, should be used to determine the amount of the revenue presented after the date of transition ('Alternative 1'). In other words, an insurer should presume that all past changes in estimates of future incurred claims and expenses were related to claims incurred before the transition date (eg experience adjustments). Consistent with the boards' past tentative decisions, the remaining revenue for those contracts would be allocated to periods after transition applying the pattern of expected claims and expenses (and release of margin at the date of transition).

28. This approach would have the following advantages:

    (a) Simplicity. The insurer would use available information required for purposes of establishing the transition date insurance contracts liability to assess the amount of revenue to be presented after transition. In evaluating this alternative, it is important to remember that its application would not affect either the measurement of the insurance

[7] The staff think that each of the liability for incurred claims and the gross amount of the present value of premiums receivable (ie the present value of expected future cash inflows) should be readily identifiable by insurers from their current insurance contracts liability cash flow estimates.

contracts liability, an insurer's equity or an insurer's net income (ie it solely affects the statement of comprehensive income presentation).

(b) Less effect of subjectivity in future revenue than would result from requiring insurers to estimate the portion of the insurance contracts liability representative of past changes in estimates of future claims. Recognising that this practical expedient is limited to circumstances where the margin was not able to be determined through retrospective application of the Standard, the subjectivity that would otherwise exist might be high. Accordingly, this alternative might enhance comparability between different insurers for contracts for which the amount of future revenue can't be determined through retrospective application of the Standard.

29. This approach would have the following disadvantages:

(a) Impaired comparability of revenue reported for some contracts in-force on transition (where retrospective application was not applied) and contracts written after transition because of different assumptions and methodology related to the total amount of revenue to be reported after transition.

(b) There could be a situation in which the total amount of the liability for remaining coverage (and consequently the amount of the revenue recognised after transition) would exceed the amount of the premiums received (after adjusting for interest accretion to be included in revenue and excluding investment component receipts). This concern could be addressed by limiting the amount of future revenue to the total expected premiums for in-force policies in the portfolio (plus interest accretion and less investment component receipts).

30. The staff considered another alternative for practical expedient ('Alternative 2'), which is determining future revenue based on the proportion of estimated future incurred claims and expenses to the expected lifetime cumulative incurred claims and expenses (ie the revenue attributable to funding the claims and expenses

multiplied by the ratio of estimated future claims to estimated total cumulative claims) plus the release of the remainder of the margin. The example below illustrates the measurement of future revenue under each of the two alternatives.

> **Example 2**
>
> Using the assumptions from Example 1 above, alternative 2 would result in future revenue of CU 476 (ie CU 450 of remaining claims / CU 950 of total expected claims X CU 900 of consideration attributable to funding the claims + CU 50 of remaining margin). This would compare to CU 500 (ie CU 450 of remaining claims + CU 50 of remaining margin) of revenue under Alternative 1 (see Example 1 for further details on the calculation).
>
> Because the amount of (non-margin) revenue to be earned under the tentative decisions of the boards should not affect the measurement of the insurance contracts liability, the CU 24 difference in revenue between these two alternatives would be reflected in the statement of comprehensive income as a 'reversal of changes in estimates of future incurred claims' for Alternative 2 that attributes some of the past changes in estimates to both claims incurred prior to the transition date and claims expected to be incurred subsequent to the transition date.

31. The staff think that Alternative 2, which acknowledges that some of the past changes in estimates likely relate to both claims already incurred and claims to be incurred, has some conceptual appeal. However, the staff believes that for contracts where it is not practicable to identify past estimates of the amount and timing of cash flows, attributing a portion of these past estimates to specific periods would be largely arbitrary. Alternative 2 is more complex than Alternative 1, which simply assumes the past changes in estimates related to past claims, and might suggest a false degree of precision.

32. On balance, the staff recommend that for the contracts in-force at transition, the amount of the revenue to be recognised after transition should be determined as follows:

    (a) For contracts for which the margin is determined through retrospective application, the insurance contract revenue remaining to be earned as of

the date of transition should be determined retrospectively utilising the assumptions applied in the retrospective determination of the margin.

(b) For contracts for which retrospective application is impracticable because it would require significant estimates that are not based solely on objective information, the remaining insurance contract revenue to be earned shall be presumed to equal the amount of the liability for remaining coverage (excluding any investment components) recorded at the date of transition (plus accretion of interest).

  (i) The liability for remaining coverage for these contracts at the date of transition shall be presumed not to consist of any losses on initial recognition or changes in estimate of future cash flows recognised in profit or loss after the inception of the contracts.

  (ii) The remaining insurance contract revenue to be earned shall be limited to the total expected cumulative consideration for in-force policies in the portfolio (plus interest accretion and less investment component receipts).

  (iii) The remaining insurance contract revenue shall be allocated to periods subsequent to the date of transition in proportion to the value of coverage (and any other services) that the insurer has provided for the period (ie applying the pattern of expected claims and expenses and release of margin).

Question 2: Determining the revenue after transition
Does the FASB agree with the staff recommendation as described in paragraph 32?