IFRS

STAFF PAPER

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Project	Insurance contracts		
Paper topic	Application of variable fee approach: revenue		
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Purpose of the paper

1. This paper explains the application of the revenue proposal for the variable fee approach used to measure insurance contracts with direct participation features (contracts that provide policyholders with payments that vary directly with the returns on underlying items).

2. The staff is not asking for any decisions at this meeting.

Layout of the paper

3. Background: revenue proposals for contracts without direct participation features in paragraphs 6-13:

   (a) Determining revenue by reference to the liability for the remaining coverage; and

   (b) Determining revenue by reference to the fulfilment cash flows and the contractual service margin.

4. Staff analysis: applying revenue proposals for the variable fee approach in paragraphs 14-22:

   (a) Separating the liability for the remaining coverage;

   (b) Excluding the investment component;

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(c) Reconciliation of acquisition costs; and

(d) Determining revenue by reference to the fulfilment cash flows and contractual service margin.

5. Examples: Illustration of amounts recognised in the statement of comprehensive income for simplified portfolio of life contracts in paragraphs 23-36.

   (a) Example 1 sets out the base case without any changes in assumptions;

   (b) Example 2 modifies the base case to include change in market rates;

   (c) Example 3 modifies the base case to include change in mortality assumptions.

Background: revenue proposals for contracts without direct participation features

Determining revenue by reference to the liability for the remaining coverage

6. In April 2014 the IASB confirmed the proposals in the 2013 ED that an entity should present revenue relating to insurance contracts. Revenue depicts the transfer of promised services arising from the insurance contract in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. In addition, the IASB tentatively decided that an entity should not present in the statement of comprehensive income any other amounts that are not consistent with revenue, such as example premiums received or premiums due in a period. Such information could be presented (and some of it is required) in the disclosures.

7. The IASB acknowledged that determining revenue for insurance contracts in accordance with IFRS 15 *Revenue from Contracts with Customers* could be challenging. Consequently, the application guidance accompanying the 2013 ED specified how an entity should measure revenue based on the information that the entity would use to measure insurance contract. In addition, the Basis for Conclusions in the 2013 ED explained how measuring revenue in this way is consistent with the approach required in IFRS 15.

8. According to IFRS 15, revenue should depict the transfer of the promised services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Applying the principle for insurance contract the entity would:

   (a) recognise revenue in each period as the entity satisfies the performance obligations (primarily bearing risk and standing ready to provide coverage) arising from the insurance contract; and

   (b) exclude from revenue (and expenses) any investment components, because the receipt (and repayment) of investment components does not relate to the provision of services to the customer.

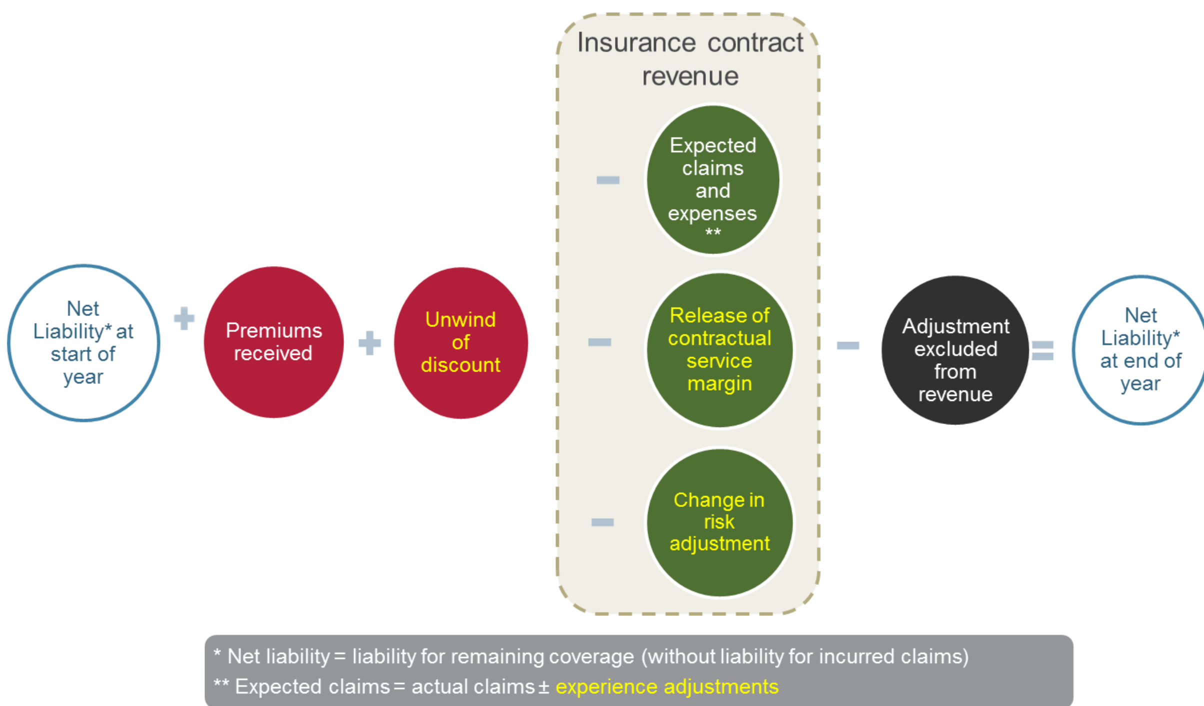
9. In the 2013 ED, the IASB noted that revenue for insurance contract can be mechanically determined using the change in the liability for the remaining coverage. This is because the liability for the remaining coverage represents the obligation to provide the remaining services needed to fulfil the contract. As a result, recognising revenue at the amount of the reduction in the liability for the remaining coverage would depict faithfully the entity's performance in providing services for the period, provided that the liability for the remaining coverage is adjusted to eliminate changes that do not relate to the satisfaction of the performance obligation. Those adjustments:

   (a) would exclude from insurance contract revenue the part of the change in the liability for the remaining coverage that arises either from losses on initial recognition or subsequent losses (and any subsequent changes of those losses). Those losses could arise from changes in expected cash flows and changes in risk.

   (b) would ensure that losses immediately recognised in profit or loss would not be recognised as part of revenue in the period but would rather be treated as an expense in a way similar to expense for onerous contracts.

10. The total amount of revenue presented over the duration of the contract would equal the premiums received for services, adjusted for the time value of money.

11. The diagram below illustrates how insurance contract revenue could be determined using changes in the liability for the remaining coverage.



Determining revenue by reference to the fulfilment cash flows and the contractual service margin

12. As can be seen from the diagram in paragraph 11, insurance contract revenue can also be expressed as the sum of:

    (a) the latest estimates of the expected claims and expenses relating to coverage for the current period, excluding those amounts recognised immediately in profit or loss. That amount excludes any repayments of investment components included in those estimates of expected claims;

    (b) the amount of the contractual service margin recognised in profit or loss in the period; and

    (c) the amount of the risk adjustment[1] recognised in profit or loss in the period.

[1] In the 2013 ED, insurance contract revenue included all changes in the amount of risk adjustment. However, at its March 2014 meeting, the IASB decided that changes in risk adjustment related to future coverage would be recognized as an adjustment to the contractual services margin rather than recognized immediately in profit or loss. Consequently, the amount of insurance contracts revenue for the period would be only related to the amount of risk released in the profit or loss for the period rather than total change in risk adjustment as proposed in 2013 ED.

13. The 2013 ED notes that the premium paid by policyholder includes the following amounts that could not be determined directly from the change in the liability for remaining coverage:

    (a) amounts that relate to investment components. An investment component is defined as the amount that an entity is required to repay to the policyholder regardless of whether an insured event happens. An entity excludes such amounts from insurance contract revenue and claims incurred. Consequently, an entity would be required to exclude (i) any amounts paid at maturity or surrender of the policy, and (ii) the amount of cash surrender values that are implicit in amounts paid when an insured event happens.

    (b) amounts that the entity charged to recover directly attributable acquisition costs. For the purpose of measuring insurance contract revenue, an entity allocates the part of the premium relating to the recovery of directly attributable acquisition costs over the coverage period in the systematic way that best reflects the transfer of services provided under the contract. The entity recognises an offsetting expense in the period (ie for the same amount that is included in insurance contract revenue for the period).

Staff analysis: applying revenue proposals for the variable fee approach

Separating the liability for the remaining coverage

14. As noted in paragraph 9, an entity will measure revenue for insurance contracts at the amount of the release from the liability for remaining coverage. To do so, an entity needs to separate the liability for the remaining coverage from the liability for incurred claims. The 2013 ED defines:

    (a) the liability for remaining coverage as an entity's obligation to pay valid claims that arise under existing insurance contracts for insured events that have not yet occurred (ie the obligation that relates to the unexpired portion of the coverage period).

(b) the liability for incurred claims as the obligation that an entity has to investigate, and pay claims for, insured events that have already occurred, including incurred claims for events that have occurred but for which claims have not been reported (IBNR).

15. For contracts with direct participation features, the biggest part of the total liability would relate to the liability for remaining coverage. This is because the contracts are generally long duration contracts which are settled shortly after the end of the coverage period. An entity would need to separate any claims (or other expenses) that have already occurred but have not yet been paid. The staff believe that such exercise should be similar comparing to contracts with no direct participation features and therefore should not impose additional issues.

16. In addition, an entity would need to separate from the liability for remaining coverage any amounts related to losses previously recognised in profit or loss (when contract was loss making). An entity would need to track this amount for the recognition purposes because the IASB tentatively decided that if there are favourable changes in the estimates an entity needs to reverse previously recognised losses before it could rebuild the contractual service margin.

Excluding the investment component

17. The release from the liability for remaining coverage includes the amounts related to the investment component that has not been unbundled (ie separated from the insurance contract and accounted for using a different IFRS). According to 2013 ED, an investment component is defined as the amount that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. For contracts with direct participation features, the investment component would be related to any payments that vary directly with the returns of the underlying items and any other payments independent from the benefits paid because of the insured event. Such amounts would need to be excluded from revenue for insurance contracts.

18. The staff expects that the amount of the disaggregated investment component would be significant for many contracts with direct participation features. This is because those contracts are designed to substantially pay to the policyholder the underlying items plus the return on the underlying items. Accordingly, those

underlying items are considered investment components. However, the staff expects that it might be less complex to exclude an investment component for contracts with direct participation features. This is because the most significant concern identified by constituents for excluding the investment component was related to the amounts included in claims that would meet the definition of the investment component (for example the amounts of cash surrender value). For contracts with direct participation features an investment component is frequently an explicit amount that an entity clearly differentiates from the amounts paid because of death (and only in this circumstance). Furthermore, current accounting practice often excludes such explicit investment accounts from the amounts recognised as revenue.

Reconciliation of acquisition costs

19. Similar to the requirements for contracts without participation features, an entity would need to allocate some portion of the premium related to directly attributable acquisition costs. This requirement does not differ from the one for contracts with direct participation features.

Determining revenue by reference to the fulfilment cash flows and contractual service margin

20. According to paragraph 12, revenue for contracts with direct participation features could also be explained as the sum of:

    (a) the latest estimates of the expected claims and expenses relating to coverage for the current period, excluding those amounts recognised immediately in profit or loss. That amount excludes any repayments of investment components included in those estimates of expected claims;

    (b) the amount of the contractual service margin recognised in profit or loss in the period; and

    (c) the amount of the risk adjustment recognised in profit or loss in the period.

21. The staff note that in some circumstances insurance risk (and expected insurance claims) are not significant for contracts with direct participation features. In those circumstances, revenue for the period would be mainly related to the release of the

contractual service margin and the risk adjustment and allocation of acquisition costs and other expenses included in the measurement of insurance contracts. This is consistent with revenue recognised for contracts where an entity receives the consideration for the services provided in the form of a fee.

22. The staff note that IFRS 15 requires that the amount of revenue recognised in profit or loss be constrained to the extent that it is highly probable that significant reversals in the amount of cumulative revenue recognised will not occur. The IASB did not propose similar requirements in 2013 ED because the IASB thought that the reasons for the constraint in IFRS 15 did not apply in the insurance contracts model.

Illustration of revenue and expense for simplified portfolio of life contracts with direct participation in the investment

23. In the following paragraphs the staff provides a simplified example that illustrates the recognition pattern of revenue for a portfolio of life contracts with direct participation features. There are three examples that illustrate different scenarios:

    (a) Example 1 sets out the base case without changes in assumptions;

    (b) Example 2 modifies the base case to include a change in market rates;

    (c) Example 3 modifies the base case to include changes in mortality assumptions.

Example 1: Base case without changes in the assumptions

24. This example considers the following fact pattern:

    (a) An entity issued a group of similar insurance contracts that end after six years (maturity of the contract) where:

        (i) policyholders pay a single premium of CU1,000 at inception of the contracts and an entity immediately invests this amount. The investments are measured at FVPL in accordance with IFRS 9 *Financial Instruments;*

        (ii) an entity promises to pay the policyholder an amount on maturity of the contract determined as the fair value of the investments at that date after deducting consideration for

providing the services in the contract equal to 20% of the return on investment each period;

(iii) an entity promises an additional fixed amount in the event of the death of the policyholder which is paid immediately to the beneficiaries when the death occurs. The expected cost of death benefits is estimated to be CU 44[2] (present value (PV) of CU 35);

(iv) an entity has paid the commission for obtaining the contract (acquisition costs) of CU 10 at inception of the insurance contract;

(v) an entity pays all expenses from the entity's share in the investment.

(b) The market interest rate at inception equals 8% pa and the risk free rate equals 6% pa. Consequently, an entity expects:

(i) to pay to the policyholder at maturity the amount of CU 1,451 (PV of CU 914); and

(ii) the total consideration for the services provided of CU 113.

(c) The risk adjustment is assumed to be immaterial.

(d) The contracts are priced to be profitable. The contractual service margin at inception equals CU 40 calculated as the difference between:

(i) the PV of the consideration ie shareholder's share in the underlying items of CU 86 calculated as the difference between premium CU 1,000 and the PV of payment to the policyholder at maturity of CU 914;

(ii) PV of mortality expenses equals CU 35; and

(iii) the acquisition costs of CU 10.

(e) The contractual service margin is recognised in profit or loss as the service is provided. In the example, service is provided on a straight-

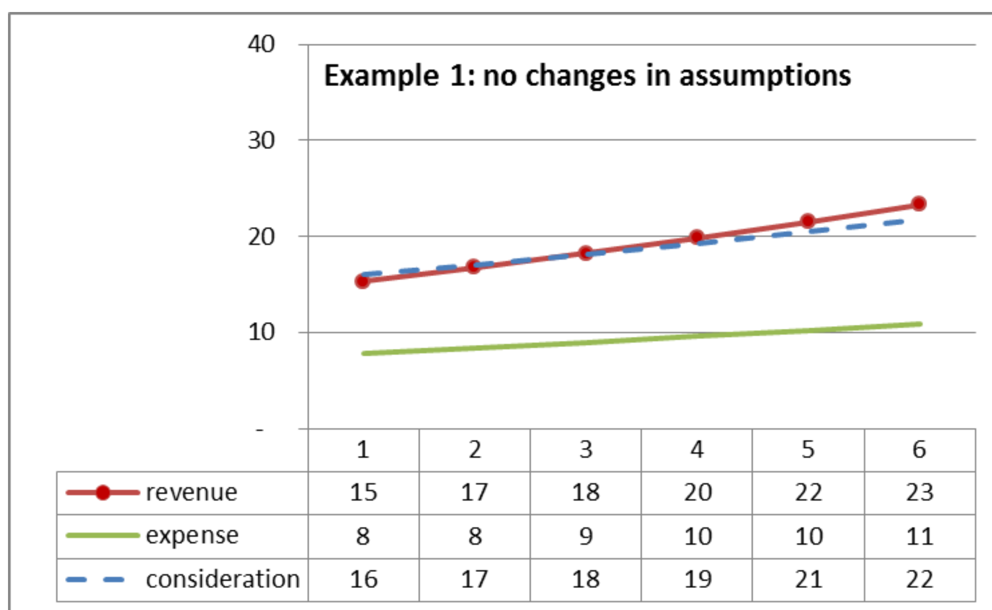
[2] Please note that the example could have rounding errors.

line basis[3]. Interest is accreted on the contractual service margin using the updated discount rate.[4]

(f) Because the purpose of this example is to illustrate underwriting (operating) activity, the investment activity is omitted.

(g) During the coverage period everything occurs as expected and the entity does not change any assumptions.

25. The graph below illustrates the amounts an entity would report as revenue and expense at the end of each reporting period. In addition, this example illustrates the consideration for the services provided.



	1	2	3	4	5	6
revenue	15	17	18	20	22	23
expense	8	8	9	10	10	11
consideration	16	17	18	19	21	22

26. The total expenses equal CU 56 and reflect the amounts of the claims incurred and the amortisation of the acquisition costs for each period. Those expenses increase over time mainly because the mortality rates increase with age. In addition, acquisition costs are amortised in line with the pattern of the service provided. This amortisation means that there is a timing difference between when the costs were paid and when those costs are recognised in profit or loss. As a result, the

[3] The IASB has not yet decided the pattern of release of the contractual service margin for the variable fee approach. Agenda Paper for the March 2015 meeting considered whether the release pattern of the contractual service margin should be the pattern of time (ie straight line basis).

[4] The 2013 ED proposed that the interest on the contractual service margin should be accreted using the discount rate at inception of the contract. In the variable fee approach, the rate used to accrete interest would implicitly be a current rate. Agenda paper 2D considers the rate used to accrete interest for indirect participation contracts.

total amount of acquisition costs recognised in profit or loss equals CU 12 which comprises the at-inception payment of CU 10 and interest accreted of CU 2.

27. The revenue recognised in each period reflects the consideration to which the entity expects to be entitled in exchange for providing services in the period. Therefore it reflects the amount of consideration relating to the expenses of providing services (ie amount of claims and other expenses) and the profit the entity charges to provide those services. Total revenue of CU 115 equals the part to cover expenses equals CU 56 and the profit of CU 59. The profitability of this contract equals 59% (profit / revenue).

28. The calculation of revenue takes into account the difference between the time the service is provided (and revenue is recognised) and the time when the policyholder paid for that service (the consideration is charged for the benefit of the insurer). Consequently, the total revenue would equal the total consideration adjusted to reflect the time value of money. In the example, the total revenue of CU 115 comprises total consideration received of CU 113 plus interest accreted of CU 2. In the example, the policyholder prepays for the early years for the services provided in the future periods.

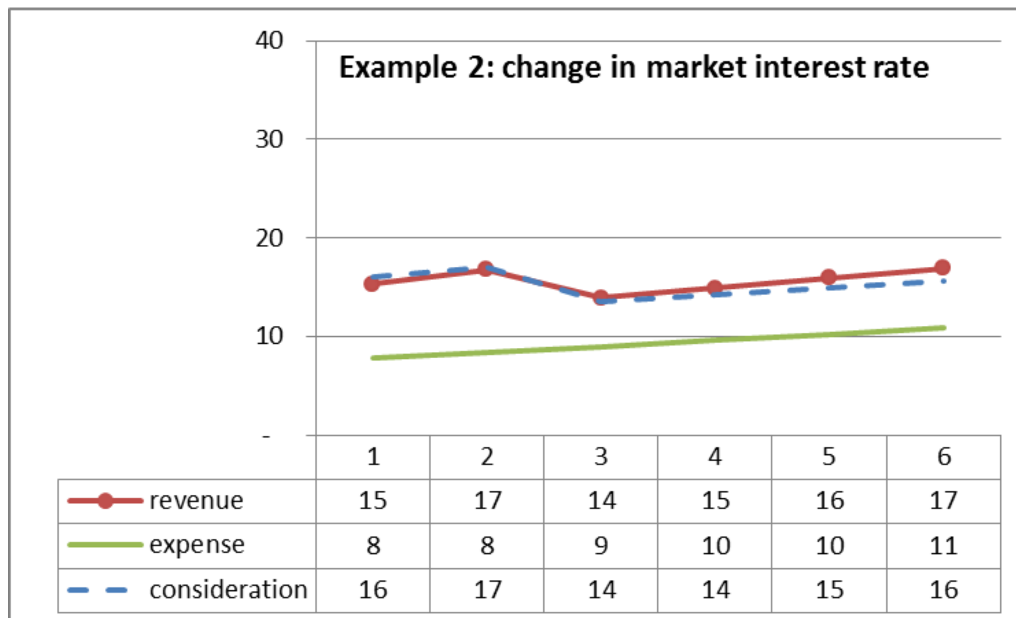
Example 2: change in the market interest rates

29. Example 2 illustrates how revenue would be affected by changes in the market interest rates. To illustrate this aspect of the proposal, Example 2 uses the same assumptions as Example 1, but assumes changes in market rate in year 3 (and all future periods) from 8% to 6%. As a consequence, an entity revises its estimates related to the investment. The value of the investment in Year 6 decreases and therefore:

    (a) Expected total investment return paid on maturity to the policyholder decreases by CU 85 (from CU 1,451 to CU1,366);

    (b) Expected total consideration for the services provided under the insurance contract that depends on the expected returns on the investment decreases by CU 21 (from CU 113 to CU 91). As a consequence of this change, the total expected profit and revenue decreased.

30. The graph below illustrates the amounts the entity would report as revenue and expense at the end of each period. In addition, this example illustrates the consideration for the services provided.



	1	2	3	4	5	6
revenue	15	17	14	15	16	17
expense	8	8	9	10	10	11
consideration	16	17	14	14	15	16

31. The amount of revenue in each period is the compensation the entity expects to receive for the services provided in the period. The variable fee approach requires an entity to record the changes in the contractual service margin. This means that the contractual service margin and therefore revenue would be more variable comparing to the measurement model proposed for contracts without direct participation features. According to the variable fee approach, such variability reflects the fact that an entity agreed to receive the consideration for the service provided under the contract that depends on the changes in market variables.

32. The total revenue of CU 94 could be considered as sum of:

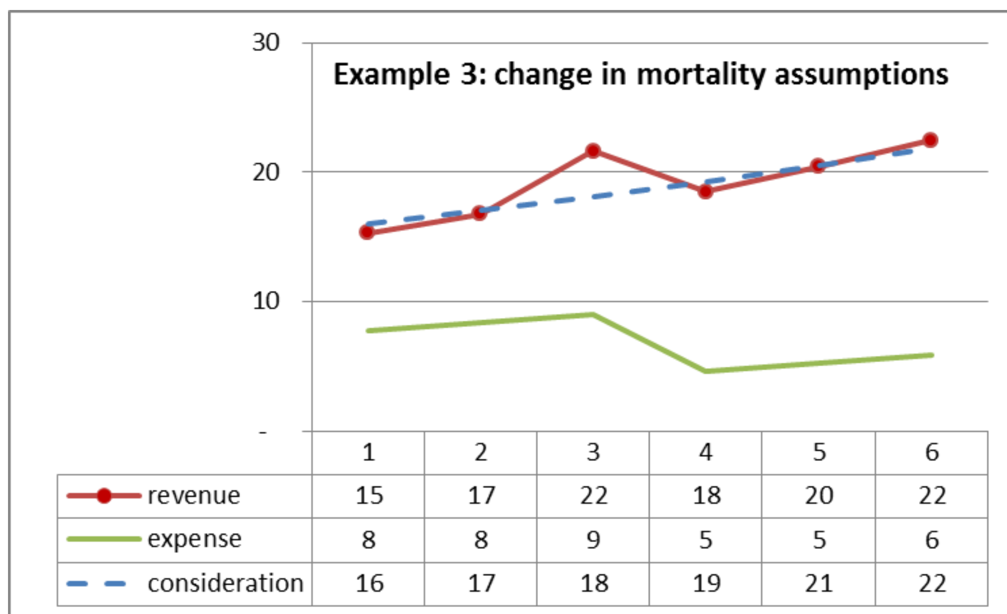
    (a) CU 56 of revenue to cover expenses and CU 38 of profit. Consequently the total profitability of this contract equals 45%. The decrease in market interest rates decreased the profit considerably comparing to Example 1.

    (b) CU 91 of consideration received and CU 3 of interest. An entity received consideration slightly before it provided the services.

Example 3: contracts affected by change in mortality assumptions

33. Example 3 illustrates how revenue would be affected by changes in mortality assumptions. To illustrate this aspect of the proposal, Example 3 uses the same assumptions as Example 1, but adds a change in mortality assumptions at the end of year 3. In this year, someone has invented a cure for some disease and mortality has improved in future periods. In year 3 the total expected claims in Years 4-6 decreased by CU 15 (from CU 24 to CU 9). The present value of this change (CU 13) decreases the expected cash outflows and increases the contractual service margin in Year 3.

34. The graph below illustrates the amounts the entity would report as revenue and expense at the end of each period. In addition, this example illustrates the consideration for the services provided.



	1	2	3	4	5	6
revenue	15	17	22	18	20	22
expense	8	8	9	5	5	6
consideration	16	17	18	19	21	22

35. The revenue represents the amount that the entity charged for the services in the period. The change in mortality assumptions in year 3 for the following years means that an entity expects to pay less claims and therefore earn more profit than initially expected. Such change does not affect the consideration charged for the services provided and therefore would not change the total revenue. However, it would change the allocation pattern of revenue because it changes the assumptions in the liability measurement that are used to allocate revenue between periods.

36. The total revenue of CU 115 could be considered as the sum of:

(a) The revenue to cover expenses of CU 41 (decrease of CU 15 compared to Example 1) and the profit of CU 74 (increase of CU 15 compared to Example 1). The profitability of this contract increased from 43% to 73%.

(b) The consideration received of CU 113 and the interest of CU 2 (which did no change compared to Example 1). The revenue is recognised in a different pattern comparing to Example 1. This is because higher profit for this contract is recognised towards the end of the contract and there is a different pattern of the expenses incurred.

Question to Board Members
Do you have any comments or questions regarding the application of revenue proposals for contracts with direct participation features?