

Life Insurance

Basic Issue 8 What Assumptions and Conventions Should be Used in Accounting for Life Insurance Contracts

371. Basic Issue 8 builds on the discussion in Basic Issues 4 to 7. It deals with the following issues that are important mainly in a life insurance context:
- (a) are the Steering Committee's tentative views in Basic Issues 4 to 7 appropriate for life insurance contracts;
 - (b) what assets and liabilities do life insurance contracts create;
 - (c) should the various assets and liabilities created by a life insurance contract be combined into a single recognition and measurement scheme; and
 - (d) should IASC prescribe a single accounting model for life insurance contracts; and
 - (e) should IASC prescribe a single income attribution approach for life insurance contracts?
372. Life insurance contracts cover mortality, and include life insurance, annuity, disability, and pension contracts. These contracts usually provide for insurance coverage over a period of several years and may be financed through periodic premiums or a single payment on inception. Payments by the insurer on the death of a policyholder are usually fixed by the contract, although annuity and similar contracts may require payments over an extended period or until death. The life insurance cycle and several accounting models for life insurance are examined in greater detail in Appendix A in the accompanying booklet.
373. Most general insurance contracts are for a fixed period of short duration, usually one year or less. General insurance contracts do not typically create rights and obligations **in the contract** beyond the end of the period covered by the current premium. (Some have argued, however, that general insurance contracts may create constructive obligations that extend beyond the current premium period. Sub-issues 6A and 7H discuss these issues.) In contrast, many life insurance contracts grant the policyholder valuable rights not usually found in general insurance contracts. The insurer usually has no right to cancel these policies during their term, although it may have the right to change the price of some elements of the contract.
374. In Sub-issue 1K, the Steering Committee concluded that it should develop accounting models for general insurance and life insurance that are separate, but based on the same underlying principles. The Steering Committee also concluded in Sub-issue 1K that, for financial reporting purposes:
- (a) insurance should be treated as general insurance if the insurer is committed to a pricing structure for not more than twelve months. Most general insurance contracts are for a short term and the insurer is free to change premiums after

the end of the period covered by the current premium, or even to decline to renew the contract; and

- (b) insurance should be treated as life insurance if the insurer is committed to a pricing structure for more than twelve months. For many life insurance contracts, the insurer has limited or no ability to reset premiums and is required to continue to provide cover if the policyholder continues to pay premiums. This requirement to continue providing cover is a source of additional liabilities (and, perhaps, assets) that do not arise in contracts that do not have this feature.

Life Insurance Accounting Models

375. Life insurance accounting models differ from one another in three ways. They:

- (a) build on different views of the contract and relationship between the insurer and policyholder;
- (b) build on different views of the source and pattern of income earned by the insurer; and
- (c) use different assumptions about the inflows and outflows from a book of contracts and, in some cases, adjustments to those assumptions.

376. The source and pattern of the insurer's net income from a contract is often said to "emerge" over time as a function of one or more contract elements. For example, depending on the approach:

- (a) income emerges as a function of premiums received;
- (b) income emerges as a function of the spread between investment returns on invested assets and the present value of payments to policyholders;
- (c) income emerges as a function of release from risks assumed by the insurer;
- (d) income emerges as a function of changes in the economic value (embedded value) created when a new insurance contract is sold; or
- (e) income emerges as a function of margins between amounts charged to policyholders and costs incurred by the insurer.

377. Finally, a life insurance accounting model must address the amortisation of acquisition costs, if those costs are capitalised as an asset. Some models incorporate acquisition costs as part of a comprehensive approach to all inflows and outflows. Other models amortise acquisition costs in a separate computation.

Sub-issue 8A Are the Conclusions Reached in Previous Issues Applicable to Life Insurance?

378. The Steering Committee recognises the significant economic and contractual differences between general and life insurance. However, several issues discussed earlier in this paper are equally applicable to accounting for life insurance contracts, as summarised in Table 7.

Table 7 Application of Earlier Conclusions to Life Insurance

Basic Issue 1

- For investment-linked insurance contracts, premiums received may need to be split into a risk component (revenue) and an investment component (deposit).

Basic Issue 4

- The Steering Committee generally favours an asset-and-liability measurement approach to recognition and measurement of insurance activity, rather than a deferral-and-matching approach.
- In general purpose financial statements, overstatement of insurance liabilities should not be used to impose implicit solvency or capital adequacy requirements.

Basic Issue 5

- The measurement basis adopted for an insurer's liabilities should be consistent with the measurement basis adopted for its assets.
- In general, the actual measurement of liabilities should not be affected by the type of assets or by the return on those assets (except where the amount of benefits paid to policyholders is directly influenced by the return on specified assets, as with certain participating contracts and unit-linked contracts). However, the Steering Committee is evenly divided on the effect of future investment margins in a fair value model (see Sub-issue 11G). Some members believe that the future investment margins should be considered in determining the fair value of insurance liabilities. Other members believe that they should not.

Basic Issue 6

- The established practice of accounting for groups of similar contracts is consistent with the diversification of risk inherent in an insurance activity. The unit of account should be a group of contracts that have substantially the same contractual terms and were priced on the basis of substantially the same assumptions.
- The Steering Committee favours a closed book approach, which comprises existing contracts (including renewals where existing contracts commit the insurer to a specified pricing structure for the renewals). The closed book excludes both new contracts and other renewals of existing contracts.

- Future cash flows that may arise from possible renewals of an insurance contract do not arise directly from the contract. Under IAS 38, Intangible Assets, it is highly unlikely that they would be considered to give rise to a recognisable asset for the insurer that issues the contracts.
- An explicit approach to assumptions is superior to an implicit approach.

Continued

Table 7 Application of Earlier Conclusions to Life Insurance (continued)

- An approach to measurement should focus on current information and assumptions.
- Measurement should be based on market expectations.
- Measurements should use an all-future-events approach to measurement assumptions, to the extent practicable, consistent with the requirements of IAS 37, Provisions, Contingent Liabilities and Contingent Assets.
- The measurement of insurance liabilities should reflect the risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties.
- The risk adjustment for a small portfolio should be the same as for a large portfolio because the additional diversifiable risk inherent in a small portfolio is irrelevant for investors who are able to diversify their investments.
- A fresh-start approach should be used to report changes in accounting estimates. The effect of differences between actual experience and earlier assumptions should be recognised immediately.

Basic Issue 7 (Conclusions that are relevant to both general and life insurance)

- An insurer should recognise claims payable as a liability. An insurer's liability for claims payable includes claims that have been reported, claims incurred but not reported, and claim handling expenses. Claim handling expenses should be recognised based on the manner in which the insurer expects to settle the related claim liabilities.
- An insurer should recognise a provision for unexpired risk, rather than provisions for unearned premium and premium deficiency. The provision for unexpired risk is the present value of estimated future claim payments arising from future insured events that are covered by existing insurance contracts. The provision for unexpired risk will also include an estimate of refunds that the insurer will need to pay to policyholders who cancel existing contracts during the term of the contracts.
- Because the measurement of insurance liabilities should reflect the risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties, the initial measurement of the liability at inception may be less than the premium charged to the policyholder. Consequently, an insurer may recognise a gain when it sells

an insurance contract. The Steering Committee recognises that some commentators may have reservations about this change from existing practice. The required margin to reflect risk will be recognised as income as the insurer is released from risks assumed at inception.

- Acquisition costs should be recognised as an expense.

Continued

Table 7 Application of Earlier Conclusions to Life Insurance (continued)

- Insurance liabilities should be based on discounted (present value), rather than undiscounted, measurements. To the extent that estimated cash flows reflect the risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties, the discount rate should be a risk-free rate. To the extent that estimated cash flows do not reflect this risk, the discount rate should be a risk-adjusted rate.

Basic Issue 6 (Conclusions that have limited or no relevance to life insurance)

- The open-year model and zero-balance model are not appropriate for most insurance activities. However, occasions may arise in which estimates cannot be made with sufficient reliability and periodic reporting is not possible. In those situations, the Steering Committee favours the zero-balance model, which it considers consistent with IAS 18, Revenue.
- An insurer should recognise its potential recoveries through salvage and subrogation as a reduction in its net liability to the policyholder. An insurer should measure estimated recoveries in a manner consistent with underlying claim liabilities. Once an insurer acquires salvage property or subrogation rights, the insurer has an asset to which the normal asset recognition and measurement criteria should be applied.
- The Steering Committee favours an asset-liability approach to accounting for retrospectively-rated contracts. In some cases, such retrospective rating may eliminate insurance risk for the reinsurer or may create a non-insurance element that may need to be accounted for separately. Retrospectively-rated contracts present certain similarities to participating contracts
- In the view of a majority of the Steering Committee, catastrophe and equalisation provisions do not meet the definition of a liability articulated in IAS 37 and the Framework. (A minority concludes that they do meet the definition.)

Tentative Steering Committee View

379. *In the Steering Committee's view, the conclusions presented in Table 7 should also apply to life insurance contracts.*

Sub-issue 8B What Assets and Liabilities are Created by Life Insurance Contracts?

380. In Basic Issue 7, the Steering Committee identified the following items that are associated with contractual rights or obligations arising from a general insurance contract and that may be candidates for recognition as assets or liabilities:
- (a) claims payable - liabilities for insured events that have already occurred, including claims that have been incurred but not reported (IBNR), claims that have been reported but not paid, and related claim handling expenses;
 - (b) liabilities for insured events that may occur during the remaining term of the contract;
 - (c) acquisition costs;
 - (d) recoveries on unsettled claims, such as salvage and subrogation, and potential recoveries on future claims covered by current insurance contracts; and
 - (e) provision for catastrophes or equalisation.
381. The Steering Committee concluded tentatively in Basic Issue 7 that items (a) and (b) qualify for recognition as liabilities, while item (c) does not qualify for recognition as an asset. Items (d) and (e) are not likely to be significant factors in life insurance.
382. While accounting for life insurance contracts has developed separately from accounting for general insurance contracts, the Steering Committee found the analysis developed in Basic Issue 7 useful in considering accounting for life insurance contracts. As in Basic Issue 7, the Steering Committee began its analysis of life insurance accounting by considering an insurer's rights and obligations under a life insurance contract and whether those individual rights and obligations meet the definition of an asset or a liability found in the IASC Framework. During the term of a life insurance contract, an insurer may do some or all of the following:
- (a) pay commissions and other costs to initiate the contract;
 - (b) receive periodic premiums from policyholders;
 - (c) make payments to policyholders who have terminated their contracts, either through payments of cash surrender value or refunds of unexpired premiums;
 - (d) make payments to the estate of policyholders who have died and submitted claims and payments to surviving annuitants;
 - (e) pay costs of administering the contract;
 - (f) credit policyholders with increases in contract value and charge policyholder's contracts for current-period mortality coverage and administration; and
 - (g) credit policyholders with dividends or bonuses on participating contracts.

383. The Steering Committee found it useful to evaluate the several features of a life insurance contracts by considering two sample contracts. Each contract is non-participating, that is, it does not credit policyholders with dividends. (Participating contracts are addressed in Basic Issue 9.)
- (a) A single-premium whole-life insurance contract. The contract has a single premium of 18,000 and promises a payment on death of 100,000. The contract cash value accrues interest at a fixed rate of 5.5 percent and is paid to policyholders on termination of the contract before death.
 - (b) A term-life insurance contract with a fixed annual premium of 900. The contract pays a death benefit of 100,000, and policyholders who survive to age 100 receive a 100,000 payment. The contract does not provide for any accumulated value to the policyholder. A policyholder who misses one premium payment terminates the contract and loses all rights. The insurer cannot cancel a contract as long as the policyholder pays premiums.
384. The following paragraphs discuss various items that some consider to be candidates for recognition as assets or liabilities:
- (a) an obligation to make payments on termination of the contract by the policyholder before the death of the insured;
 - (b) an obligation to make payments as a consequence of insured events that have occurred;
 - (c) an obligation to make payments as a consequence of insured events that may occur during the future period covered by the premium already received;
 - (d) an obligation to make payments as a result of insured events that may occur in a period that will be covered by future premiums under existing contracts;
 - (e) a contractual right to receive future premiums under an existing insurance contract;
 - (f) a net contractual right or obligation to receive or pay cash as a result of existing insurance contracts; and
 - (h) policy acquisition costs.

385. Readers should note that the discussion in paragraphs 386-404 considers *whether* items meet the definition of assets or liabilities found in IASC's Framework. The measurement of those items is discussed in the sections that follow.

Termination of the Contract

386. Both contracts discussed above require the insurer to make some payment if the policyholder terminates the contract before the death of the insured. The single-premium contract requires the insurer to pay a cash-surrender value. The term-life

contract requires a pro rata return of the unearned premium for the current period. (Some term-life contracts do not provide for a refund of premiums.) In each contract, the insurer has a present obligation that arises as a consequence of a past event.

387. *In the Steering Committee's view, payments that an insurer is required to make on termination of the contract by the policyholder meet the definition of a liability.*
388. The insurer's liability on the termination of a contract is relatively clear, whether through action by the policyholder or the death of the insured party. The insurer's obligation to make payments in those situations clearly meets the Framework's definition of a liability. The insurer's rights and obligations prior to those events are not as easily understood, and the question of whether those rights and obligations meet the definition of an asset or a liability is not as easily answered. Paragraphs 389-393 discuss first the insurer's obligation for events that may occur during a period for which the insurer has received (or is entitled to) a premium. The discussion then turns to the insurer's obligation for events that may occur after the end of the period covered by current premiums.

Claims Arising from Events That Have Occurred

389. *In the Steering Committee's view, payments (including related claim handling costs) that the insurer is required to make as a consequence of insured events that have occurred (policyholder deaths) clearly meet the definition of a liability, even though the claims may not have been reported to the insurer.*

Claims during the Period Covered by the Current Premium - Events Have Yet to Occur

390. Insurers adopt a variety of contractual arrangements for the payment of premiums. The typical arrangement involves the payment of a premium at or near the initiation of insurance coverage, although some contracts provide for deferred or instalment payments. In exchange for the premium, the insurer agrees to pay claims that arise during a defined period, referred to here as the *current premium period*. For the single-premium contract described in paragraph 383(a), the "current premium period" is until death or cancellation and thus covers several years into the future. For the term-life contract, the current premium period is the remaining term of the one-year premium. In each case, the insurer has an unavoidable obligation to pay any valid claim presented by a policyholder or policyholder's estate.
391. Some draw an analogy between insurance contracts and other financial instruments. In effect, the insurer has written a form of financial option in exchange for the premium payment. That "option" is exercisable by the policyholder on the occurrence of an insured event. Paragraph 27 of IAS 39, Financial Instruments: Recognition and Measurement, requires an enterprise to "recognise a financial asset or financial liability on its balance sheet when, and only when, it becomes a party to the contractual provisions of the instrument." IASC's March 1997 Discussion Paper, Accounting for Financial Assets and Financial Liabilities, adopts a similar approach. Paragraph 29(d) observes that "financial options are recognised as assets or liabilities when the holder or writer becomes a party to the contract." In either view, the insurer has a liability to make payments as a consequence of events that will occur during the current premium period.

392. Some consider the liability for unearned premiums recorded in existing insurance accounting as an attempt to capture this liability for a written option or service obligation. Others maintain that unearned premiums are a matching device and that the balance does not satisfy the definition of a liability. They argue that the event that triggers the insurer's obligation for future claims during the premium period is the death of a policyholder. In their view, until that triggering event occurs, the insurer's contractual commitment does not satisfy the definition of a liability.
393. *In the Steering Committee's view, an insurer's obligation for claims (including related claim handling costs) arising from insured events that may occur during the period covered by the current premium meets the definition of a liability and should be recognised as such.*

The Insurance Contract

394. Many insurance contracts require the policyholder to pay periodic premiums, often monthly or yearly. Other contracts may not require periodic premiums, but policyholders routinely renew. Still other contracts are automatically renewed unless the policyholder notifies the insurer. However, as a matter of law and contract, an insurer usually cannot compel policyholders to pay future premiums. Similarly, the insurer has no obligation for an insured event that may occur during a period beyond the current premium period. In the usual case, a policyholder's failure to pay a renewal premium simply terminates the contract.
395. Some suggest that the insurance contract (as opposed to the extra-contractual relationship) creates rights and obligations that may create a net asset or liability.¹⁴ The Steering Committee found it useful to consider this view by referring to the term-life contract described earlier.
396. The term-life contract is certainly a valuable asset for some policyholders. For example, a term-life policyholder who bought the contract described in paragraph 383(b) at age 35, and who now has reached age 80, has a valuable death benefit for a (now) very small premium. The present value of his or her remaining expected premiums is about 4,600 at 7.5 percent, while the present value of expected death benefits is about 50,000 (using hypothetical mortality assumptions). In other words, the insurer does have an obligation to accept the premium on the pricing basis specified in the contract. Thus, it may be argued that the insurer has written an option that permits the policyholder to renew the contract by paying further premiums.
397. The term-life contract considered here is non-cancellable and guaranteed renewable for a fixed price. Because of the contract, the insurer must continue to provide 100,000 of life insurance to existing policyholders for a 900 premium, year in and year out, for 65 years.¹⁵ The contract's expected cash flows probably constitute a net inflow in early years of its term and a net outflow in later years. This is a common characteristic of fixed-premium whole-life contracts. What distinguishes the term-life contract considered here from whole-life contracts familiar in many jurisdictions is

¹⁴ Refer to Basic Issue 1 for the Steering Committee's proposed definition of an insurance contract.

¹⁵ Assuming the contracts were initially sold to 35 year-old policyholders.

the lack of an accompanying cash value that the policyholder can realise if the contract is terminated prior to the death of the policyholder.

398. *In the Steering Committee's view, the combination of future premiums, expenses, and claims beyond the current premium period from contracts like the term-life contract described in this section create assets or liabilities. Those assets or liabilities exist as a consequence of a past transaction (signing the contract) that imposes benefits or sacrifices on the insurer.*
399. *In the Steering Committee's view, contracts that guarantee the policyholder's right to renew the contract and that restrict the insurer's ability to change the amount of renewal premiums create an asset or liability that would not exist in the absence of such guarantees or restrictions.*
400. *The Steering Committee observes that the contract provisions described in these paragraphs are more common in life insurance than general insurance contracts. As a result, the Steering Committee observes that most general insurance contracts do not give rise to assets and liabilities related to premiums and claims after the end of the current premium period. However, general insurance contracts in some jurisdictions include the features described in this Steering Committee view. The Steering Committee's views are based on the nature of the contractual relationships, not the nature of the insured events. Accordingly, the Steering Committee would extend its conclusions to general insurance contracts with similar features. Indeed, under the definition proposed in Sub-issue 1K, such contracts would be classified as life insurance contracts for financial reporting purposes.*

Acquisition Costs

401. The accounting treatment of acquisition costs in life insurance is closely linked to the measurement of policy liabilities. Some accounting conventions for life insurance include acquisition costs as part of an integrated approach (see paragraph A66 in Appendix A). In those cases, the capitalisation and amortisation of acquisition costs is part of the measurement of a net liability, rather than a separate recognition of acquisition costs as assets.
402. *Consistent with its tentative view in Sub-issue 7D for general insurance, the Steering Committee concludes that acquisition costs for life insurance contracts should be recognised as an expense, on the basis that they do not meet the Framework's definition of an asset. Also, the measurement of insurance liabilities already reflects the future cash flows to be generated by the insurance contract, so the recognition of an asset would lead to double counting.*

Summary of Assets and Liabilities

403. *In summary, the Steering Committee concludes that the following assets and liabilities are created by a non-participating life insurance contract:*
- (a) *a liability for payments that an insurer is required to make on termination of the contract by the policyholder;*

- (b) *a liability for payments that the insurer is required to make as a consequence of insured events that have occurred;*
- (c) *a liability for payments of claims that may occur during the period covered by the current premium; and*
- (d) *a net contractual right or obligation to receive or pay cash as a result of existing insurance contracts.*

404. *The terms of some life insurance contracts allow for a different decomposition of the life insurance contract. For example, some contracts such as **universal life**, **variable**, and **indexed** contracts allow separate identification of future charges against the contract for administration and mortality coverage, future interest credits, and future charges for early termination. The ability to separately identify contract components is a prerequisite for the policyholder-deposit accounting model discussed later in this section. However, many contracts (including the term-life contract described earlier) do not allow for this level of analysis. In addition, the individual elements listed above are included in the cash flows associated with the several assets and liabilities described in the preceding paragraph.*

Sub-issue 8C Should the Various Assets and Liabilities Created by a Life Insurance Contract be Combined into a Single Recognition and Measurement Scheme?

405. In Sub-issue 6A, the Steering Committee concluded that the established practice of accounting for groups of similar contracts (rather than for individual contracts within the group) is consistent with the diversification of risk inherent in an insurance activity. The preceding discussion of assets and liabilities raises the unit of account issue in a different context. Should the accounting model recognise and measure the several items listed in paragraph 403 as separate assets and liabilities or as a single asset or liability?
406. In Sub-issue 1E, the Steering Committee considered the unbundling of insurance contracts into separate assets and liabilities and reached the following tentative conclusion:

The Steering Committee believes that approach (a) - unbundling – is conceptually preferable but that it relies on distinctions that may be difficult to make in practice. The Steering Committee proposes that contracts should be unbundled when the separate components are either:

- (a) disclosed explicitly to the policyholder; or
- (b) clearly identifiable from the terms of the contract.

407. Some suggest that an insurer's financial statements would be enhanced by an accounting model that deals separately with each of the several assets and liabilities created by an insurance contract. In their view, such an accounting model would be similar to the accounting for general insurance contracts. Financial statement users could then separately evaluate the consequences of current period events and the insurer's exposure to the possible consequences of future events. Those who hold this

view observe that many life insurance contracts include a policyholder's account balance or cash surrender value. That amount, at a minimum, appears to meet the Steering Committee's criteria for unbundling and should, in the Steering Committee's view, be reported separately in the financial statements.

408. Others disagree and favour approaches that combine the several items in a single recognition and measurement model. In their view, the several assets and liabilities described in paragraph 403 are the joint result of a single contract with policyholders. Measuring each individual part requires estimates of the others. For example, policyholders who terminate their contracts and receive cash surrender value (if any) will not be paid death benefits. Those who hold this view point to the body of well-established actuarial practice that considers all cash flows in a single set of computations. They agree, however, that the insurer should make explicit assessments of each element, consistent with the Steering Committee's conclusion in sub-issue 6B.
409. Still others favour a selective view that bases the selection of an approach on the characteristics of the insurance contract. In their view, a model that recognises and measures individual contract elements is especially useful for contracts (such as the universal, variable and indexed life products discussed above and some single-premium products) that have a significant policyholder investment element. Those contracts are characterised by a balance that accumulates value based on premiums paid and interest credited (either explicitly or through fixed patterns of cash surrender value).
410. Some suggest that premium inflows and claim outflows that arise from an insurance contract should be reported separately. They point out that IAS 32, financial Instruments: Disclosure and Presentation, generally prohibits the offset of assets and liabilities except in certain carefully specified circumstances. However, others argue that the premium inflows and claim outflows are not separate assets and liabilities. They take the view that the insurer's rights and obligations under the contract create a single net liability or asset. Therefore, they consider that the offsetting requirements in IAS 32 are not relevant.

Tentative Steering Committee View

411. *In the Steering Committee's view, the insurer's rights and obligations under the contract create a single net liability or asset. Therefore, the Steering Committee favours an approach to accounting for life insurance that combines the various assets and liabilities created by a book of contracts in a single recognition and measurement scheme. Similarly, the Steering Committee considers that the offsetting requirements in IAS 32 are not relevant.*
412. *The conclusion in the previous paragraph does not apply to those components of insurance contracts that are unbundled under the tentative Steering Committee view in Sub-issue 1E.*

Sub-issue 8D Should IASC Prescribe a Single Accounting Model for Life Insurance Activities?

413. The Steering Committee must consider whether the needs of financial statement users are best served by an International Accounting Standard that:
- (a) specifies a single recognition model (benefit or deposit) for all life insurance contracts;
 - (b) specifies different models depending on the type of life insurance contract involved; or
 - (c) allows insurers to choose which recognition model best meets their circumstances.
414. From time to time, IASC has allowed enterprises a choice between accounting methods. Those choices rarely involve an issue as fundamental as the basic recognition model. The Framework states that similar assets and liabilities should receive similar accounting. Many would be disturbed by the possibility that two insurers, perhaps operating in the same jurisdiction and offering the same mix of contracts, might adopt fundamentally different recognition models for the same type of contract.
415. Previous sections of this paper contrasted two approaches to insurance accounting - a deferral-and-matching approach and an asset-and-liability-measurement approach. A deferral-and-matching approach attempts to associate revenues and related expenses, with an emphasis on the amount and timing of reported income. An asset-and-liability-measurement approach focuses on balance sheet measurements, with reported income representing the effect of changes in the carrying amounts of assets and liabilities.
416. Accounting models used by life insurers generally fall into one of two categories.
- (a) **Policyholder-benefits** (prospective) models measure the liability for policyholder benefits by focusing on future premium inflows and outflows for policyholder benefits and expenses. Policyholder-benefit models usually report the entire amount of premium as revenue when received and report payments to policyholders as benefits. As they are used in current practice, most applications of policyholder-benefit models are consistent with a deferral-and-matching view. The assumptions and techniques are designed to produce a particular pattern of reported income (refer to Appendix A). The resulting liability balance is the amount necessary to produce that pattern. As a result, policyholder-benefit models are usually considered consistent with a deferral-and-matching approach. However, prospective techniques can be used to provide a direct measurement of the insurer's liability that is consistent with an asset-and-liability-measurement approach.
 - (b) **Policyholder-deposit** (retrospective) models measure the liability to policyholders based on the accumulation of past transactions between the insurer and policyholders. Policyholder-deposit models usually report

premiums as increases in a deposit liability. Payments to policyholders are divided between return of that deposit and net benefits in excess of the deposit. Policyholder-deposit models are consistent with the asset-and-liability-measurement view. The insurer's liability is characterised as a deposit and the pattern of reported income is largely governed by explicit contractual provisions and reporting to the policyholder.

Policyholder-Benefits (Prospective) Model

417. In a policyholder-benefits model, premiums are recognised as revenue on receipt, with a corresponding (but not necessarily equal) entry to record a **liability for policyholder benefits** and an expense. Payments on the death of a policyholder or on contract surrender are reported as benefit expense. The liability for policyholder benefits is a present value, and it increases as interest accrues to the balance. The liability is increased or decreased at the end of each period based on the number and, in some applications of this model, the actuarial expectations of contracts in the book that remain in force.
418. As mentioned above, policyholder-benefits models are usually applied in a manner consistent with a deferral-and-matching view. However, there is significant disagreement about the pattern in which income should be attributed to individual years, as outlined in Appendix A.
419. Illustrations A18-A22 in Appendix A portray the workings of a simple policyholder-benefits model.

Policyholder-Deposit (Retrospective) Model

420. This model is used in some jurisdictions instead of the policyholder-benefit model. Premiums are recognised as a deposit liability rather than as revenue. This deposit balance represents the policyholder's equity in the contract. In some cases, the amount is communicated in annual reports provided to policyholders. In others, an aggregate deposit balance is computed for financial reporting purposes, but individual deposit balances are not communicated to policyholders. In other cases, the policy surrender value is deemed to represent the policyholder's deposit balance.
421. While retrospective approaches have existed for some time, the policyholder deposit model became popular with the advent of policies that include variable terms and grant a measure of discretion to both the insurer and the policyholder. Those policies are variously known as universal life, unit-linked, variable, and indexed policies. While their terms differ, they each include a policyholder account that is used to communicate activity from period to period and functions much like an account with a bank or broker. The policyholder's premiums are credited to this account, as are investment earnings, and the account is charged for administration and mortality protection. If the policyholder surrenders the contract, he or she is entitled to the balance of the account, less any surrender charges.
422. A policyholder-deposit model may also have implications for the amounts reported as revenues and expenses. In some jurisdictions, premiums received by the insurer are not reported as revenues. Instead, premiums are reported as additions to liabilities.

Revenues include amounts that the insurer charges against the policyholder's account for mortality coverage, administration, and early termination of the contract. This form of accounting is similar to the accounting that most banks use for their deposit liabilities.

423. Illustrations A31-A34 in Appendix A of the accompanying booklet portray the workings of a simple policyholder-deposit model.

Models Compared

424. Table 8 compares the policyholder-benefit and policyholder-deposit approaches. Both approaches lead to an answer that can be analysed as the present value of future cash flows, but the elements of that computation differ between the approaches.

Table 8 Policyholder-Benefit and Policyholder-Deposit Approaches Compared		
Cash Flow	Policyholder-Benefit Approach	Policyholder-Deposit Approach
1. Future premiums	Included - computed net premium in traditional attribution methods (see illustrations A19, A27), but may use gross premium.	Not included (do not affect account balance) - Gross premium is credited to account balance as it arises.
2. Future amounts assessed against policyholder's account for administration and mortality	Included through the estimate of benefit outflows	Not included (do not affect account balance) – but reduce the amount of any premium deficiency.
3. Future expenses incurred by the insurer for policy maintenance, renewal premiums, claim handling, etc.	Included	Not included (do not affect account balance) unless a premium deficiency exists
4. Future surrender charges	Included through the estimate of benefit outflows	Included to the extent that they (a) affect the account balance or (b) where there is no account balance, affect the cash surrender value
5. Payments on death of the insured that represent a return of policyholder's account balance	Included through the estimate of benefit outflows	Included
6. Payments on death of the insured in excess of the policyholder's account balance	Included through the estimate of benefit outflows	Not included (do not affect the account balance) unless a premium deficiency exists
7. Discount rate	Depends on objective and attribution method	Rate credited to policyholder accounts

Tentative Steering Committee View

425. *In the Steering Committee's view, a prospective (policyholder-benefit) approach is consistent with its view of a life insurance contract as a single set of interrelated assets and liabilities. However, the amount recorded as a liability should not be less than the amount that would result from applying a retrospective (policyholder-deposit) approach. The Steering Committee expects that a prospective approach,*

applied without restriction based on the retrospective approach, would be more consistent with an estimate of fair value.

426. *In reaching the view outlined above, Steering Committee members noted the following points that influenced their deliberations:*

- (a) *when considered in a traditional (rather than fair-value) context, accounting for life insurance has typically focused on the service provided by the insurer. Traditional policyholder-benefit approaches attempt to report earnings from the contract as the service is provided. In this regard, they are similar to accounting for other long-term contracts, as described in IAS 18, Revenue; and*
- (b) *the liability recognised in a policyholder-deposit model - the policyholder's account balance - is a financial liability that is typically payable to policyholders on demand (although it may be subject to surrender charges or penalties). When considered in a traditional context, the balance of this financial liability represents a minimum measurement of the liability.*

Implementing the Steering Committee View

427. Applying the Steering Committee view in paragraph 425 requires the insurer to compare the amount computed using a policyholder deposit (retrospective) approach with the amount computed using a policyholder benefit (prospective) approach. In implementing this approach:

- (a) the policyholder-deposit amount (the minimum liability) is equal to the account balance that accrues to the benefit of policyholders, after deducting any surrender charges that would apply if the contracts were terminated prior to the death of the insured. If the contract has no account balance but has a cash surrender value, the cash surrender value is used. If the contract has no account balance or cash surrender value (as is the case with the term-life contract discussed earlier in this chapter), the policyholder deposit amount is the amount, if any, that must be refunded if a policyholder terminates the contract prior to the death of the insured. Unless the insurer has the ability to recover additional amounts from policyholders who terminate contracts before the death of the insured, the minimum amount computed under the policyholder deposit approach is zero;
- (b) the policyholder-benefit amount represents the present value of expected premium receipts, less the present value of expected payments to policyholders, payments for contract administration, and payments for claim handling. Consistent with the tentative Steering Committee view expressed in Sub-issue 6F, assumptions used in developing those estimates should be adjusted for the amount that marketplace participants would demand for bearing the uncertainty inherent in estimates of future cash flows. Because adjustments for risk have been incorporated in cash flows, present value should be computed using a risk-free rate of interest; and

- (c) consistent with the Steering Committee view expressed in Sub-issue 6G, changes in estimates, changes in market conditions, and current period experience different from assumed amounts should be reflected through a fresh-start measurement of the liability and the effect of those changes should be reported in income.

428. Illustrations A35-A38 in Appendix A of the accompanying booklet provide an example of the Steering Committee view applied to a hypothetical book of life insurance contracts.

Sub-issue 8E Should IASC Specify a Single Attribution Approach for Life Insurance Contracts?

429. The carrying amounts of the insurer's liability and deferred costs (if any) are inextricably linked to the pattern of reported income over the term of the policies. This truism has led to a lively debate over the sources of income (sometimes referred to as **profit carriers**) in a book of life insurance policies. Most life insurance policies have elements of sales, service, assumption of mortality risk, and investment. Income attribution approaches attempt to identify one or more of those functions as the source of income and to measure the liability so that net income is reported as that function is performed. Income is thus "attributed" to individual years over the life of a book of contracts using accounting conventions designed to produce a pattern of recognised income (if events unfold as expected) that is consistent with the source of income.

Tentative Steering Committee View

430. *In the Steering Committee's view, the income attribution approach should be the result of the liability measurement. Accounting conventions that produce liability measurements as a by-product of a predetermined pattern of reported income are inconsistent with an asset-and-liability-measurement approach.*
431. *The Steering Committee observes that if its view is applied, income emerges as a function of contract margins for those periods in which the liability to policyholders is computed using the policyholder-deposit measurement. Income emerges as a function of release from risk for those periods in which the liability to policyholders is computed using the policyholder-benefit measurement.¹⁶*
432. *The Steering Committee observes that other approaches to measuring the insurer's assets and liabilities give rise to other patterns of income attribution. Some of those patterns are illustrated in Appendix A. The Steering Committee invites comments from readers who consider one or more alternative approaches superior to the approach that flows from the Steering Committee's tentative views.*

¹⁶ If insurance liabilities are measured at fair value, income will emerge as a function of release from risk.