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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2009, London**
Project:	**Insurance Contracts**
Subject:	**Comparison with preliminary views on Revenue Recognition (Agenda paper 10C)**

Purpose of this paper

1. This paper provides background information to support agenda paper 10A. It compares the measurement candidates for insurance contracts with the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (DP on revenue).

2. This paper does not identify a preferred measurement approach for insurance contracts.

3. The rest of this paper deals with the following subjects:

   (a) Why look at revenue recognition? (paragraphs 4-8)

   (b) Measurement model for revenue recognition (paragraphs 9-17)

   (c) Measurement objectives for candidates 1-4 (paragraphs 18-22)

   (d) Measurement features of candidates 1-4 (paragraphs 23-32)

   (e) Unearned premium approach (paragraph 33).

Why look at revenue recognition?

4. In December 2008, the boards released their DP on revenue. This discussion paper invites comments on the boards' preliminary views on a single, contract-based allocated transaction price approach for revenue recognition. The proposed model would apply to contracts in which an entity promises to transfer to a customer an asset that is an output of the entity's business operation activities. The DP on revenue refers to such a promise as a performance obligation.

5. Insurance contracts are contracts between an entity (the insurer) and a customer (the policyholder). The insurer promises to provide insurance coverage to the policyholder. This promise creates a stand ready obligation: the obligation to investigate claims made by the policyholder and to pay valid claims. It may be useful to distinguish two stages of the insurer's obligation:

   (a) standing ready to pay valid claims: the insurer provides the policyholder with continuous coverage against a specified uncertain future event (insured event) throughout the coverage period.

   (b) handling and paying out a claim: once a policyholder made a claim, the insurance contract requires the insurer to assess, manage and, if valid, pay out the claim. A claim can be paid in cash or in kind. During the process of claims handling, the obligation is still subject to uncertainty; in many cases this uncertainty may be considerable.

6. The discussion paper *Preliminary Views on Insurance Contracts* (DP on insurance contracts) distinguishes two types of liabilities for the activities mentioned in paragraph 5 (a) and (b); a pre-claims liability and a claims liability. However, both liabilities come from a contract (insurance contract) with the customer (policyholder) and, arguably, relate to the same performance obligation (standing ready to accept and pay claims):

   (a) the insurer transfers an asset (namely insurance coverage) to the policyholder continuously throughout the coverage period. Some contracts result in claims by policyholders.

   (b) the insurer subsequently investigates claims and pays claims to those policyholders who made valid claims. That payment is, arguably, part of fulfilling the insurer's stand ready obligation because the insurance company is arguably not fully released from the performance until it either rejects or pays out the claim.

7. Throughout the life of the contract the insurer provides a range of activities; for example policy issue, policy administration, claims investigation, claims administration and claims payment. In the previous paragraph we concluded that these activities are more or less directly related to standing ready to pay claims; transfer of the associated asset (insurance coverage through accepting and paying claims) can stretch beyond the coverage period in case of claims. However, some policies include activities that are available on a stand-alone basis more generally, eg. fund management services or car repairs. Those services transfer assets throughout the period those services are provided, which sometimes coincides with the life of the contract.

8. The revenue recognition project deals with revenue from contracts with the customer. Therefore, revenue from insurance contracts will be within the scope of a future revenue recognition standard unless the boards create a scope exclusion. The proposed measurement model for revenue recognition results from the board's most recent thinking on contracts with customers. It therefore seems natural to compare that thinking with the measurement candidates for insurance contracts.

Measurement model for revenue recognition

9. In the DP on revenue the boards focused on measurement of the performance obligations; they will deal at a later stage with the measurement of the consideration receivable from the customer (rights). This paper therefore focuses on the measurement of a performance obligation.

10. The DP on revenue defines a performance obligation from a contract with customers as follows:

> **a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer**

11. An entity fulfils its performance obligations by transferring the promised goods and services to the customer. To clarify, although this description includes the word 'transfer', it does not look at transfer to a third party at the reporting date. Rather, it refers

to a fulfilment of the performance obligation over time by a transfer of an asset (good or service) to the customer.

12. The DP on revenue explained that, conceptually, the measurement of a performance obligation should reflect:

    (a) expected cost

    (b) time value of money

    (c) a margin.

13. In the DP on revenue, the boards took the position that these building blocks should be used to measure the performance obligations by reference to the original transaction price, ie the consideration the customer promises in exchange for the promised goods and services. At initial recognition the performance obligations are measured at the original transaction price (unless the contract is deemed to be onerous). Subsequent measurement is by allocating the original transaction price to the remaining performance obligations, supplemented by an additional amount if the contract is deemed onerous. This model is often referred to as the allocated transaction price approach. In effect, this approach defines the building blocks as locked-in cash flows, zero discount rate (locked in) and a locked in margin, supplemented with different building blocks for the onerous test.

14. Using the allocated transaction price approach, an entity recognises neither a contract asset nor revenue at contract inception. Some think this is a useful depiction of an entity's position and performance in the contract. Others think that an asset probably exists at contract inception and revenue therefore could **arise** (in principle), but believe that it is not appropriate to **recognise** that contract asset and revenue at contract inception.

15. The allocated transaction price approach uses the observable transaction price at contract inception. The boards' preliminary view in the DP on revenue is that using that price avoids the cost and complexity of an entity searching for another price or estimating one if it is not observable.

16. The boards' preliminary view in the DP on revenue is that the onerous contract test should not include a margin; this is also referred to as a cost test (whereas a test including

a margin would be referred to as a price test). Some prefer that approach because it is similar to some existing standards and might not change significantly the frequency of remeasurement in practice. Others support a cost test because they do not favour using the allocated transaction price approach for most performance obligations that would need an onerous test.

17. We now compare the allocated transaction price approach with the candidate measurement approaches for insurance. We first look at the measurement objective. We then discuss the features of the allocated transaction price approach that could be problematic for insurance contracts.

Measurement objectives for candidates 1-4

18. Within candidates 1-4 we identify two measurement objectives: transfer to another party (candidate 1) and fulfilment with the policyholder (candidates 2-4). How do these objectives compare to the proposed allocated transaction price approach?

19. In the previous section we explained that the measurement approach proposed in the DP on revenue (allocated transaction price) works from the basis that the performance obligations to the customer are fulfilled over time. From the perspective of an allocated transaction price approach, it is probably more natural to think of fulfilment by the entity rather than a market participant. The fulfilment candidates are arguably more in line with this objective than current exit value.

20. We also explained why the boards chose an allocated transaction price model for the DP on revenue. Some may argue that some of those arguments also apply to the fulfilment candidates for insurance contracts:

    (a) a fulfilment approach avoids cost and complexity associated with those estimates that cannot be observed in the market.

    (b) a fulfilment approach could arguably avoid a day one difference based on the principle of consistency with the boards' preliminary views on revenue recognition; an exit approach may require a rule to avoid day one differences.

21. In their revenue recognition project, the boards rejected a current exit price approach (ie transfer approach) for the following reasons:

(a) Pattern of revenue recognition - the boards concluded that an entity should not recognise revenue before it transfers a promised asset (good or service) to the customer.

(b) Complexity- a current exit price would rarely be observable for the remaining performance obligations in the contract. This would lead to a need for estimates, which may be difficult to verify and may not produce information that is sufficiently decision-useful to justify the cost. Also, many think it is counter-intuitive to use a measurement approach based on transferring obligations to a third party when, in most cases, the entity neither intends nor has the ability to transfer them. Many think the measurement approach should reflect the fact that the entity intends to satisfy its performance obligations by providing the goods and services promised in the contract.

(c) Risk of error - if an entity fails to identify (or measure correctly) a performance obligation at contract inception, the entity would recognise too much revenue at contract inception. Under a current exit price approach it might be difficult for an entity to establish whether revenue (and profit or loss) recognised at contract inception result from measurement error rather than from an increase in the entity's net contract position.

22. Based on the analysis in this section we believe that the concept of fulfilment value fits more naturally within the measurement objective the boards selected in the DP on revenue; a current exit value (candidate 1) may be more difficult to reconcile with some aspects of the approach in the DP on revenue.

Measurement features of candidates 1-4

23. In paragraph 13 we mentioned how the allocated transaction price approach can be analysed using three building blocks mentioned in the DP on revenue. The DP on insurance refers to the same building blocks, but defines these building blocks differently; features include for example current measurement, market interest rates and explicit margins. This difference in the building blocks causes potential problems for both the exit approach and the fulfilment approaches.

24. The outcome of an insurance contract can be highly variable because uncertainty is an inherent characteristic of insurance contracts and some of those contracts cover many reporting periods. In the boards' view, the model proposed in the DP on revenue therefore might provide decision-useful information for some contracts that the insurance project is considering but not all of them.

25. We believe that it will be difficult for a allocated transaction price approach to come up with a useful answer for insurance contracts unless it is developed in a way that involves:

  (a) explicit current estimates of cash flows, reflecting the inherent variability of cash flows from insurance liabilities. The allocated transaction price approach remeasures the performance obligation only when onerous.

  (b) time value of money. Given the long duration of many insurance contracts, measurement of the insurance liability should reflect time value of money. Although the measurement of performance obligations conceptually includes time value of money, the boards have not addressed this issue in the DP on revenue. The boards will look at a later stage at time value of money for both rights (ie the consideration receivable from the customer) and performance obligations.

  (c) explicit margins. Explicit estimates of margins ensure that financial reporting does not represent two liabilities as the same if one liability is more risky than the other. Explicit estimates are also likely to result in estimates that are more robust with reduced risk of insurers overlooking changes in circumstances. The allocated transaction price approach includes a margin (a composite margin). However, this margin is implicitly included in the measurement of the performance obligation. The onerous test is a cost test and does not include a margin.

26. Other potential issues are:

  (a) Acquisition costs. Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract with a policyholder. The allocated transaction price approach does not allow any income to be recognised on day one to cover these acquisition costs. This could result in significant day one losses for insurers in many cases.[1]

(b) Allocation of the premium ('top line' of the performance statement): the allocated transaction price approach requires an entity to recognise the consideration (premium) as it satisfies the performance obligations. This may cause some presentation issues for some types of insurance contracts. For example, consider single premium immediate annuities. In many existing accounting models, the insurer would recognise the premium received as revenue on receipt and at the same time recognise (i) a liability and (ii) an expense (the increase in that liability). In contrast, the allocated transaction price approach would require the insurer to recognise a slice of the premium as revenue as it fulfils each slice of the performance obligation over the life of the contract. We will discuss performance reporting at a subsequent meeting.

27. The issues mentioned in paragraph 25 and 26 can be split into measurement issues and presentation issues. The former affect profit or loss ('bottom line'), while the latter are relevant to the presentation of revenue and other items within the performance statement ('top line'). The issues in paragraph 25 and 26(a) relate to measurement, although some presentation may be involved. Paragraph 26(b) is a presentation issue.

28. One way to deal with these issues is by developing a second measurement approach for the future revenue recognition standard that also gives information about changes in circumstances. Paragraph 5.100 of the DP on revenue explains that the allocated transaction price approach might be viewed as a less burdensome way for entities to arrive at a reasonable approximation to the second explicit measurement approach. In the DP on revenue, the boards did not express a preliminary view on whether or how to apply a second measurement approach.

29. The boards could also deal with these issues by excluding insurance contracts from the scope of a future revenue recognition standard that uses the allocated transaction price

[1] The DP on revenue specifies that acquisition costs may qualify for recognition as an asset in accordance with other standards.

approach if the boards conclude that this approach is not appropriate for insurance contracts[2].

30. However, some may feel that excluding insurance contracts from the revenue recognition standard is unsatisfactory because they see no reason for insurance contracts to be (or remain) a 'special case'. But does excluding insurance contracts from the revenue recognition standard automatically result in a different treatment? We believe that is not necessarily the case.

    (a) If the boards select an exit price notion as the measurement approach for insurance contracts, insurance arguably would not be unique. In that case measurement will be consistent with the standards on fair value measurement, although the boards will have to address the issue of day one differences in the case of insurance contracts and revenue recognition for service components (eg. fund management services) may differ from stand-alone service contracts.

    (b) If the boards select one of the fulfilment candidates, the measurement model for the insurance project could be developed to be as consistent as possible with the preliminary views expressed in the DP on revenue, particularly on initial measurement. On the other hand it could deal with the issues of an allocated transaction price approach, which are likely to coincide with the concerns expressed in the DP on revenue about an allocated transaction price approach for some types of contract with customers. Paragraph 5.100 of the DP on revenue took the position that an explicit measurement approach does not necessarily result in inconsistencies with the allocated transaction price approach, provided that both models are consistent on initial measurement.

31. We believe that an explicit measurement approach for insurance contracts most likely needs to be covered by a separate insurance standard. The boards still have to decide whether to develop a second measurement approach in the revenue recognition project. Even if the revenue recognition project develops a second measurement approach, we may still need a separate insurance standard to deal with other aspects of insurance

[2] The boards consider a third option, which is disclosure. We do not specifically address this option because we believe that decision-useful information about changes in circumstances (often significant) for insurance contracts would be captured better by recognition and measurement.

contracts. Such aspects could relate to recognition, performance reporting, disclosures and possibly even measurement.

32. A measurement approach developed within the insurance project could contribute to the boards' consideration within the revenue recognition project on the development of another measurement approach. It could also help the revenue recognition project to deal with other contracts within the scope of that project that are similar to insurance contracts, for example warranties.

Unearned premium approach

33. The unearned premium approach (candidate 5) is the easiest to tie into the proposed allocated transaction price approach. The unearned premium approach allocates the original transaction price (the insurance premium) over the coverage period. The insurer fulfils its performance obligation continuously over the coverage period by transferring to the customer an asset (the insurance coverage) and recognises revenue as it does so. However, potential issues are:

    (a) acquisition costs: the allocated transaction price approach does not allow for any day one revenue. This could result in significant day one losses for insurance contracts, even for those that are of a short duration.

    (b) margin in the onerous test: the onerous test for the allocated transaction price approach does not include a margin. If the boards adopt the unearned premium approach for all (or more likely some) types of insurance contract, they will need to decide whether the liability adequacy test includes a margin.