

Linkage:  
Revenue Recognition  
and the  
Insurance Contracts Project

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Basel

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# Measurement of Insurance Contracts

- “Exit Value” was adopted as the measurement attribute for the IASB Insurance Contracts Discussion Paper (ICDP) by a very narrow margin and was broadly opposed in the comments to the ICDP.
- Linkage of measurement of insurance contracts to other major projects has always been a significant concern.
- Revenue Recognition -- a prime example.

# Revenue Recognition

- When the ICDP was written, the preliminary view of the IASB was that Revenue Recognition would be on a “Fair (Exit) Value” basis.
  - Broadly, would have recognized revenue as the difference in change of assets minus change of liabilities.
- “Customer Consideration” was noted as an alternative.
  - Broadly, for executory contracts, recognizes revenue equal to the value of consideration exchanged with the customer.
  - No gain at issue for service contracts.

# Revenue Recognition

- Insurance Project Staff conducted R&D of both bases.
- The Revenue Recognition Project now has its own Discussion Paper (RRDP). Comments are due 18 June 2009.
- Customer Consideration has been adopted by the IASB and FASB for use in the RRDP by a significant majority.
- This is a major conceptual shift since the issuance of the ICDP.

# RRDP Linkage to Insurance Contract Liabilities

## Customer Consideration in the RRDP is more appropriate for insurance contract liabilities:

- It recognizes that a contract can provide services as well as goods; RRDP, ¶¶2.10, 3.2, 3.13. Insurance contracts predominantly provide a service (insurance coverage).
- It would recognize revenue as the insurer is released from risk over the contract's coverage period; RRDP ¶5.20.
- It supports the initial transaction price as being the appropriate starting point for the pattern of recognition:
  - It is simple
  - It is the one and only market transaction in the majority of service contracts (including almost all insurance).

# RRDP Linkage to Insurance Contract Liabilities

Customer Consideration in the RRDP is more appropriate for insurance contract liabilities:

- It calibrates obligations to the consideration at the time of issue and specifically rejects any gain at issue prior to services being rendered; RRDP, ¶¶2.33, 5.20, 5.27)
- It is less hypothetical and subjective and therefore provides more decision useful information than exit value; RRDP ¶¶5.17, 5.21.

# Revenue Recognition - Details

Still reviewing the RRDP.

Many implications for Insurance Contract Accounting Project.

We will have firmer positions when we comment on the RRDP in June, these thoughts are preliminary.

# Revenue Recognition

## Some Tentative Observations

- RRDP treats the contract as a whole and indicates that the contract is the asset or liability rather than individual cash flows; RRDP, S14. This is the best overall approach to insurance contracts as well.
- The insurance contract provides the service of insurance protection over the coverage period.
  - Thus, Revenue Recognition should occur over the coverage period, not the claims period. We believe this is fully consistent with the intent of the RRDP.
  - The standard for measurement and re-measurement of reported claim liabilities would need to be in the insurance contracts standard.

# Revenue Recognition Life Insurance Concerns

- Concern with how RRDP would be extended to recurring premium contracts, since it does not address the measurement of rights under contracts. Resolution of this issue is critical (but possible) following the RRDP principles:
  - We are comfortable with the RRDP description of the 3 building blocks, although ICDP suggests current exit value which RRDP rejects.
  - It would seem logical to us, to treat future rights in the same manner, namely:
    - Include the best estimate of expected future incomes
    - Discount for the time value of money
- It makes sense to calibrate the present value of all considerations to the present value of all obligations under the contract and allow a single margin to achieve no gain or loss at issue.

# Revenue Recognition Life Insurance Concerns

- Concern initial measurement in RRDP could result in significant up front losses for most life insurance contracts, since it apparently does not allow recognition of high first year costs in estimating the year-one obligation. There are several ways this could be addressed in an Insurance Standard:
  - Allow calibration to the present value of consideration less acquisition expenses, making the measurement of the contract an asset at issue to offset high first year expenses
  - Allow an asset to be established for the value of the policyholder relationship (or similar).
  - Allow all expenses to be included in the measurement of the performance obligation
- **Not endorsing any particular approach at this time.**

# Revenue Recognition Life Insurance Concerns

- Concerned with the lack of re-measurement for performance obligations.
  - This would not work well for insurance contracts subject to policyholder behavior.
  - We urge that a standard for life insurance contracts require re-measurement of expected costs on a regular basis whether the general revenue recognition standard requires it or not.

# Summary

The Customer Consideration approach in the RRDP is a good starting point.

# Summary

There are nuances that are specific to insurance contracts that will need to be clarified in the insurance contracts project/guidance, such as:

- Treatment of heaped first year expenses or Deferred Acquisition Costs
- The performance obligation is time only (not servicing) and that the coverage period (not settlement period) is the stand ready obligation
- Treatment of rights under the contract
- Unlocking of assumptions for other than onerous contracts

# Summary

- We hope that this is useful in preparing for upcoming discussions on the insurance contract accounting project.
- Questions?