

Investment & Life Assurance Group The Practitioner Voice

International Accounting Standards Board 30 Cannon Street London EC4M6XH

18 June 2009

Dear Sirs,

Discussion Paper 'Preliminary Views on Revenue Recognition in Contracts with Customers'

The Investment and Life Assurance Group (ILAG) welcomes the opportunity to comment on this Discussion Paper.

ILAG is a trade body representing members from the Life Assurance and Wealth Management industries. ILAG members share and develop their practical experiences and expertise, applying this practitioner knowledge to the development of their businesses, both individually and collectively, for the benefit of members and their customers.

Overview

We commend the IASB's aim of developing a revenue standard that will reduce diversity between industries in practice and improve comparability; with the objective of providing decision useful information to users of financial statements.

The asset and liability approach to revenue recognition set out in the Discussion Paper may be novel for enterprises that manufacture or sell goods or provide services that are consumed over a short period. These enterprises may not traditionally have thought of their contractual arrangements with customers as giving rise to obligations (and hence liabilities).

However, the focus on the measurement of liabilities resulting from contracts with customers is not new to insurers. Indeed, the largest balances on insurer's balance sheets are liabilities for policyholder obligations, and the investment assets that they purchase with policyholder premiums. For this reason, any standard that deals with liability measurement is of vital importance to our industry. Of course, revenue is a very important number for us too.

We think that it is in the interests of the insurance industry to have accounting standards that are based on similar principles to those of other industries. It is not helpful to us if users regard our financial statements as opaque and inconsistent with other industries. We support clear, consistent, and transparent reporting that seeks wherever possible to represent faithfully the financial effect of transactions and other events.

We welcome the attempts of the IASB to establish a single framework for accounting for revenue transactions. We also agree, however, with the view expressed in the Discussion Paper that the proposed allocated transaction price approach will not provide decision useful information for some types of insurance contracts. The Discussion Paper singles out long term contracts with variable outcomes, where there is a risk of significant changes in

circumstances over the term of the contract. For our members such contracts are commonplace. We are familiar with the particular challenges that the proposed model will pose for our industry and do not think that it is an acceptable basis either for measuring our performance obligations, or for recognising revenue.

Characteristics of insurance contracts

The way in which the insurance industry operates is different from other industries. The contracts that our members write contain a number of complex features for the measurement of liabilities and the recognition of revenue. This means that, in developing common principles, it is necessary to make them flexible enough to deal with the complexities of our industry if we are to meet the objective of providing decision useful information.

The Discussion Paper acknowledges some of the complications, but we would like to highlight the problems that the proposed model creates for us:

- Life Insurers earn money from investment management services and by taking on uncertain risk from a large portfolio of clients. Insurance works by allowing individuals to pool their risk and in so doing benefit from being part of a portfolio. While individual parts of that portfolio will be subject to risks of significant volatility, the portfolio as a whole exhibits much less volatility as a result of the law of large numbers. The portfolio concept is vital to insurance, in explaining the way that it works, and to providing decision useful information to others. A standard that focuses on contracts with individual customers, and does not take a **portfolio approach**, can result in misleading information. There should be provisions in a liability measurement standard to recognise and measure insurance contracts on a portfolio basis.
- Investment management services aside, insurers earn revenue, not by providing goods or services, but by standing ready to provide indemnity or financial compensation. They do not transfer assets to each policyholder, but instead create an asset for those policyholders by pooling risk. This provides policyholders with 'peace of mind' as they know that, should an adverse event happen, the insurer will compensate them. The language in the Discussion Paper about **revenue** only being **recognised when assets transfer** from the company to the customer is not suitable for insurance. This could be read as implying that revenue can only be recognised when claims are paid to those policyholders that do claim, rather than over the period that the insurer is standing ready. We would be surprised if this was the intention of the Discussion Paper.
- Life insurers enter into long term contracts with their policyholders and need to make a number of assumptions when determining pricing and liabilities for their portfolios of business. These assumptions include expected mortality and morbidity rates, future interest and inflation rates, future returns on investments, and the number of policyholders that will lapse or surrender policies early. All of these assumptions need to be updated regularly if financial reporting is to be relevant. A measure that **locks** these **assumptions in at inception** will not result in decision useful information.
- Since life insurers generally enter into long term contracts with their customers, they pay significant acquisition costs to secure them. They recover these costs from charges to policyholders as part of the premium. The Discussion Paper proposes that performance obligations be measured at the transaction price including amounts charged to recover acquisition expenses. This means that the entire transaction price is assumed to relate to future goods and services and that no revenue can be recognised on day one. A model which prohibits the recognition of amounts charged to recover acquisition costs as revenue, and spreads them over the term of the contract, will result

in misleading information if that model does not also require the costs to be spread. We think that costs should be expenses as incurred, but that insurers should be allowed to recognise revenue on inception equal to the amount of acquisition costs incurred to represent economic reality.

Traditionally life insurers allow policyholders to pay level premiums for each year of their long term contracts. This creates a difficulty under the allocated transaction price approach of defining exactly what the transaction price is. Is it the full premiums for all years on one contract? Is it the full premium for a portfolio of contracts adjusted for the number of policyholders expected to lapse? Or should it only be one year's worth of received premium on each contract? The answer to this question matters because, in the latter case, the policyholders in year one could be seen as paying a premium for one year's worth of cover plus an amount to insure against declinatures in their future insurability. In the former case, the pattern of payment of premiums would not impact on the total amount of revenue recognised. This question needs to be addressed for the industry in a way that results in decision useful information.

The life insurance industry is amongst the largest investors in financial assets, such as gilts, bonds and equities, which it uses to meet its obligations to policyholders. These financial instruments are reflected at fair value on the balance sheet in accordance with IAS 39 *Financial Instruments: Recognition and Measurement.* If insurers are required to carry their liabilities on the balance sheet on a non-current, locked-in basis, this will result in an **accounting mismatch** on the balance sheet between assets and liabilities. This mismatch will not reflect economic reality.

Investment management charges

Apart from insurance services, life insurers also earn revenue from charges to policyholders for investment management services. We do not anticipate many problems arising from the proposed standard for this type of revenue. However, we note that further clarification is needed on how contingent fees would be accounted for in the proposed model. Specifically, we would welcome clarity on whether the revision of estimates of **revenue to be received** after that revenue has been recognised in the previous financial statements, could result in the recognition of negative revenue amounts in the current financial statements.

Recommendation

We recommend that, given the complexities surrounding them, insurance contracts be scoped out of the revenue project. The IASB has a separate project on accounting for insurance contracts which has been ongoing for over ten years.

We support the use of common principles in developing the two standards. Indeed we acknowledge that, in its deliberations to date, the IASB has sought to be as consistent as possible in making decisions in the two projects. We have also noted how discussions in one project help the board to come to conclusions in the other. Keeping the projects separate will not only make things less unwieldy for the IASB, but it will also reduce uncertainty for the insurance industry. At present our members must follow developments in two different projects. If the IASB decides to proceed with the project in a way that includes insurance contracts in its scope we would recommend that the allocated transaction price approach is retained as the core revenue recognition model. The IASB should then develop a second model (an allowed alternative) that preparers can choose to apply to their contracts as a matter of accounting policy choice. This is in line with the options that entities currently have in other IASB standards' such as IAS 16 *Property, plant and equipment* and IAS 40 *Investment Properties* where entities can chose between cost and revaluation models. We would suggest that entities could adopt the alternative model if they believe that the simple

locked-in transaction price does not provide decision useful information.

We would support an alternative similar to the building block approach set out in Appendix B to the Discussion Paper. In this model, the costs and time value of money are updated for current assumptions while the margin is locked in at inception and earned over time.

We propose a variation on that model in that we would suggest that the combination of the expected costs and time value of money building blocks be recognised as a liability and be updated for current assumptions. The residual, resulting from increasing the liability to the transaction price on day one, should be shown as a separate deferred income liability and earned over time as the services are provided. Also, as noted below, we propose that the IASB (either in its main or alternative models) allow companies to take revenue on day one equal to the amount of acquisition costs incurred.

Responses to questions

Our responses to the questions posed in the Discussion Paper are set out in the appendix attached to this letter.

If you would like to	discuss our response i	n more detail we would	be happy to do so.

Yours faithfully

Lynda Maynard

Administration Team

Appendix

Responses and comments to 'Preliminary Views on Revenue Recognition in Contracts with Customers'

Question 1

Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We agree with the concept of a single revenue recognition principle based on changes in assets and liabilities resulting from contracts with customers. However, we think that the focus on the 'net' contract asset or liability is not necessary and, based on the model that the IASB is focusing on in the project (transaction price); the application of the net contract approach can be misleading. We think that it is better to link the recognition of revenue to decreases in the total performance obligation only. Given that the IASB's model requires the performance obligation to be measured at the transaction price, we do not think that the asset needs to be dealt with in this standard.

An example of where this focus on the net contract asset is confusing and misleading is shown below. This example illustrates a case where the principle that revenue is recognised from increases in the net contract position does not appear to work. It highlights the difficulty with applying the principle, or at least, that there is scope for the principle to be better illustrated.

Example

A company enters into a contract to provide services evenly over a period of three years to a customer. The amount that the customer agrees to pay is set out in the contract, and is due in instalments. If the total contract price is CU 1,000 the following pattern of payments might be agreed: nothing paid upfront, CU 100 paid at the end of year one, CU 400 paid at the end of year two, CU 500 paid at the end of year three. In this example the net contract position would appear as follows:

End	Year 0	Year 1	Year 2	Year 3
Rights	1 000	900	500	-
Performance obligation	(1 000)	(667)	(333)	-
Net contract asset/ (liability)	-	233	167	
Cash	-	100	500	1 000

In the example above, the company has performed in years 1, 2 and 3 and should seemingly recognise CU 333 of revenue in each year as it satisfies its obligations and the value of the performance obligation decreases. However, the net contract asset increases in year 1 but does not increase in year 2 or 3. If, under the proposed model, revenue is only recognised when the net contract position increases, then it would appear that no revenue would be recognised.

We do not understand why an obligation of the customer to pay the company would be shown as part of a net contract asset or liability. Amounts due from customers have always been accounted for as receivables under IAS 39. Indeed, the concept of offsetting the right to receive payment and the obligation to provide goods or services appears to be in conflict with the general rules for netting assets and liabilities as described in IAS 39 and IAS 1 *Presentation of Financial Statements*.

Question 2

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

Please refer to our response above.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

We agree that the principle of separating performance obligations on the basis of when services are provided to customers is a sound one. However, given that many insurers may find it impractical to separate cash flows for composite products that they sell into the different elements, we would suggest that the IASB conduct field testing to find out if this can be practically achieved. If this is only possible with a high degree of subjective judgement then we would suggest that the split might become arbitrary and not provide decision useful information. In this case we would prefer not separating the obligation to reporting an arbitrary split.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

No, we are sympathetic to the arguments in paragraphs 3.39-3.41 of the Discussion Paper which characterise the return of goods as a failed sale rather than a performance obligation. We have noted our view that the revenue recognition standard should allow for measurement on a portfolio basis. This is an example of where looking at a portfolio rather than an individual contract provides decision useful information.

This question is linked to another question of importance to the life insurance industry regarding the inclusion of future non-contractual premiums. Many life insurance contracts require policyholders to pay premiums for a number of years to retain their coverage. Insurers are able to estimate what percentage of customers will keep paying and what percentage will allow their policies to lapse. They see these long term contracts as single contracts stretching over a period of years, rather than as yearly contracts with an option to renew. This is reflected in the contractual constraints that the insurer is under as a result of

these contracts – for example, the insurer may not terminate the contract if it feels that the insurer has become a higher risk.

If we see these contracts as long term contracts with the option to cancel, then, in the same way as an entity estimates the proportion of customers that will return a good, the insurer can estimate the proportion of customers that will allow their policies to lapse. The insurer therefore recognises on day one the premiums that it expects to receive from its policyholders in determining the value of the performance obligation. The amount of revenue recognised would of course be only that portion that relates to services provided in the current reporting period.

Question 7

Do you think that sales incentives (eg discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

We think that if sales incentives relate to the current sale they should be taken into account in determining the amount of revenue recognised. However sales incentives for future sales should not give rise to revenue until the future sale actually takes place. Sales incentives for future sales are enticements to do business or enter into contracts in the future – the company might publish discount coupons in the press as easily as handing out discount vouchers upon completed sales. Regarding future sales incentives as part of the current sale gives rise to the problems raised in the Discussion Paper regarding where one should place a limit on what should and what should not be regarded as revenue producing sales incentive.

Paragraph 3.27 of the Discussion Paper refers to an example where a manufacturer (TuneCo) gives two types of sales incentives to its customer. In the first example it gives the customers CU 40 of free music. In the second it offers a 40% discount on a purchase of CU100 of music in future. Where the customer has been given something and needs only to take delivery of that item (in this case the CU 40 of free music) then this should be accounted for as part of that original sale. However, where the sale incentive is for a future discount (like the 40% discount on CU 100), a prospective customer has to take action in future and agree to buy a good or service and enter a new contract with the company. The company might even decline to transact in the future, or run out of stock. Therefore, this should only be accounted for as revenue if, and when, that transaction happens.

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

The terminology used in the Discussion Paper focuses on the transfer of an asset resulting in the recognition of revenue. This language is also used in the context of providing services, with the IASB noting that services can be seen as assets that are consumed immediately. This poses a problem for the insurance industry. Insurance companies stand ready to pay financial (or other) compensation to policyholders if an insured event occurs. Language that focuses on the transfer of an asset needing to take place before revenue can be recognised would seem to suggest that, for insurance contracts, revenue can only be recognised when claims are paid because this is the only point when an asset (usually cash) is actually transferred from the insurer to the policyholder.

We are certain that this is not what the IASB intended for insurance contracts. The service that is provided by insurers is the provision of 'peace of mind' that, if an event occurs, the insured is covered – this service is provided each day that the policy is in force. We agree that the insured would see this as an asset (a resource controlled as a result of a past event from which future economic benefits are expected), albeit an asset which might not be recognised on the balance sheet. However, it is not an asset that the insurer has and transfers to the policyholder. Instead the insurer creates an asset for the policyholder through portfolio assembly. It takes the risk of the individual policyholders and combines them such that it can take risk away and pay out to those policyholders that need to claim. We suggest that the language in the Discussion Paper should be refined to better address the provision of services.

Question 9

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Subject to our views regarding acquisition costs which are noted in our response to Question 11a below, we think this is a sound principle for the recognition of revenue. Revenue should arise as performance obligations are satisfied over time. Note that for the life insurance industry this will mark a departure from current practice in which revenue is recognised as cash is received.

Question 10

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

No, the Discussion Paper notes in paragraph 5.7 that:

- "The objective of measuring performance obligations is to depict decision-useful information about an entity's:
- (a) obligation at each financial statement date arising from its promise to transfer goods and services to a customer
- (b) contractual performance during the reporting period."

In paragraph 5.8 it notes that: "the measurement is meant to quantify the amount of assets required to satisfy the performance obligations at the financial statement date".

As noted below, we believe that the allocated transaction price approach results in a balance on the balance sheet which does not accurately reflect or quantify the value of the performance obligation.

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

We do not think that the transaction price model and its implication of locked-in assumptions

are appropriate to the insurance industry. We think that obligations should be remeasured at each reporting date and not only when deemed onerous.

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

One of the implications of using the transaction price for insurance contract liabilities is that it forces liabilities to be reflected at a locked-in value that refers to the premium charged on inception. Not only will this lead to inaccurate valuation of the liability over time, as interest rates and other assumptions change, but it will also introduce an accounting mismatch. This mismatch arises from reflecting assets at market value (in accordance with IAS 39) while liabilities would be on a locked-in value not updated for current assumptions and market prices. It also introduces a mixed-attribute model for insurer's liabilities. Liabilities that fall under IAS 39 might be accounted for at fair value, whereas insurance liabilities will be at allocated transaction price. This puts a large amount of pressure on the definition of an insurance contract.

Insurers have some experience of a lock-in type model from US GAAP statement SFAS 60 *Accounting and Reporting by Insurance Enterprises*. As a result we are aware of the problems such a model could cause. As a result of only unlocking assumptions when the cost of fulfilment exceeds the carrying value of the liability (including margin), bad news is stored up as assumptions worsen until the point that the margin (or buffer) is exhausted. At this point lock-in is broken and a number of year's worth of accumulated bad news can suddenly be recognised. Problems with asset and liability accounting mismatches also resulted in the need to introduce the complex concept of shadow accounting into US GAAP for insurers. This contributes to confusion about life insurance accounting in the mind of users, as few people are properly able to understand and apply the concept.

We recognise that there will always be a gap between what accounting standards allow us to reflect and the true economics of the business. However, we believe that the IASB should seek to reflect as accurately as possible the value of assets and liabilities on the balance sheet and that accounting should be moving in the direction of closer matching of economics and accounting rather than the other way around. Moving to a model that locks in liabilities in this way will be a regressive step which may make users more dismissive of our financial statements.

Another problem that arises with the allocated transaction price approach for insurance contracts relates to the margin. Under this approach an insurer's liability (performance obligation) is measured at the discounted costs to provide services plus a margin necessary to equate to the transaction price on inception. This liability contains a true liability plus a margin which represents future profit. This part of the liability is not a true liability – it is deferred profit. This distinction may not be important for other industries. However, insurers operate in a highly regulated environment and it is important that their balance sheets do not show as liabilities amounts which are in fact future profits.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

Yes, we believe strongly that insurance contract liabilities should be subject to a different measurement approach. The Discussion Paper states in paragraph 5.39:

'However, the boards think that an approach that explicitly measures performance

obligations at each financial statement date is unnecessarily complex for most contracts with customers. In most contracts with customers, the most significant change in an entity's performance obligations arises from the transfer of goods and services to the customer to satisfy those obligations. Changes for other reasons (eg changes in the price or quantity of goods and services yet to be transferred to the customer) are not significant in most contracts with customers. That is either because the values of the goods and services promised in those contracts are not inherently volatile or because those contracts are of short duration, which itself minimises the risk of volatility'

This paragraph is not true of the insurance industry and it should not be required to use the allocated transaction price approach as set out in the Discussion Paper. As we note in our opening comments, insurance contracts should have their own standard, or the IASB should develop a second revenue model for use in accounting for insurance contracts and other contracts for which the proposed model will not provide decision useful information.

Question 11

The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

No, we do not think that this approach provides decision useful information. Indeed it will be misleading because it will force companies to report a loss on a contract which is profitable. It is not representationally faithful and violates the principle of neutrality in reporting. It also results in inconsistent treatment between expenses and the amount charged to customers to recover those expenses. On the one hand you require entities to charge the amounts incurred in full to the income statement as incurred. One the other hand the amount that they charge to customers to recover those expenses has to be deferred and earned over the period of the contract. Either you should spread both the cost and the revenue – or spread neither.

This approach results in the reflection of a liability on the balance sheet at an amount which is not representative of the value of that liability. We recommend that entities be allowed to recognise revenue on day one equal to the amount of direct acquisition costs incurred.

(b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

Please refer to our response above.

Ends