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Comments on the IASB Discussion Paper on Revenue Recognition

The Danish Insurance Association (DIA) welcomes the opportunity to comment on the IASB's Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (hereafter the DP).

For some years the Danish insurers have been applying a current measurement model to insurance liabilities. In 2005 a larger revision of Danish GAAP for insurers was implemented in order to make the regulation compatible (not in contradiction) with IFRS. Not all options of IFRS are available under Danish GAAP and not all disclosure requirements of IFRS are implemented under Danish GAAP. With a few exceptions Danish GAAP are not in contradiction with IFRS. Changes to IFRS's are implemented in the same way in Danish GAAP for insurers on an ongoing basis. This is expected to be the case for a new standard on revenue recognition as well. The developments of the IFRS's are therefore of great importance to us.

The DIA notes in particular that the proposals in the DP do not seem to be consistent with the proposals in the DP on insurance contracts (2007) and with the measurement models currently discussed in the insurance project i.e. current exit value and current fulfilment value. The DP on revenue recognition is proposing a much more narrow definition of revenue than the one which is implicitly included in the DP on insurance contracts.

The DIA is concerned that the boards with the definition of revenue in the DP will determine not only revenue recognition but also the measurement. The measurement model proposed in the DP on revenue recognition does not provide a current measurement of the performance obligation and, therefore, will in many cases not provide a measurement which reflects the economic characteristics of the insurance liability. We do not believe that this will provide decision-useful information about insurance contracts. Insurance contracts are in many cases long term and are characterised by uncertain cash flows and therefore a current measurement is essential in order to reflect the economic characteristics of insurance contracts.

Further, the DIA is concerned about the treatment of acquisition costs in the DP. It is a problem that in the DP any amounts an entity charges a customer to re-

cover the costs of obtaining the contract (acquisition costs) would be included in the initial measurement of an entity's performance obligations. As acquisition costs are expensed before or at inception of the contract, the amounts charged to recover these costs do not relate to the remaining contract obligation and should, therefore, not be included within the liability. If amounts charged to cover these costs are included in the initial measurement of the performance obligations new business will show a loss at inception although it may be profitable from an economic point of view. The proposed measurement will in this case not reflect the economics of the insurance contract and will, therefore, not provide decision-useful information for users of financial statements.

The DIA understands that the boards aim with this DP is to provide decision-useful information about an entity's obligation at each financial statement date as well as the contractual performance during the reporting period (according to 5.7). We share these objectives stated by the boards. For some contracts with customers the boards may have achieved these objectives with the proposed revenue recognition model. However, in the view of the DIA the boards have not succeeded in achieving the objectives for a large number of insurance contracts.

We would, therefore, prefer that insurance contracts are exempted from the scope of this standard along with financial instruments in the scope of IAS 39 as proposed in the DP 5.87(a) further elaborated in 5.88-5.89 and S11.

The attached annex contains the DIA answers to the questions in the DP.

Yours sincerely,

Helle Gade

Danish Insurance Association

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?

The DIA agrees with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or liability. A keystone in the IFRS accounting principles is the definitions of assets and liabilities. A recognition principle for revenue based on changes in an entity's contract asset or liability is consistent with that key focus.

However, the DIA is concerned, that a revenue recognition principle where measurement is based on an original transaction price approach will imply, that insurance liabilities should be measured at transaction price and should only be remeasured, when the performance obligation is deemed onerous. It seems like the boards are moving away from measuring insurance liabilities and related investment assets at current exit price respectively fair value with gain and losses through profit and loss. The DIA find, that this would be a step backwards.

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?

Yes. The DIA share the view explained in the DP 5.89 and therefore support, that insurance contracts should be excluded from the scope of the revenue recognition standard. The DIA also share the view, explained in DP 5.88 that financial instruments, which currently are measured at fair value according to IAS 39, should be excluded from the scope of the revenue recognition standard.

There are several reasons for this:

- Insurance contracts are in many cases long term contracts with uncertain cash flows. As time passes changes in economic variables (such as the interest rates) may result in gains and losses when measuring the insurance liability at a current value. Such gains and losses will - unless the contract is onerous - not affect the liability when measuring at the transaction price model i.e. indicating a stability which may not present from an economic point of view.
- Insurance companies do not currently report a top line item named 'revenue' in the statement of comprehensive income, instead they report premium income. It therefore does not seem logic for insurance contracts to be included in the scope of an IFRS regarding 'revenue' recognition. We assume, however, the purpose of the DP is to cover the recognition of all income/profit related to a customer contract including gains and losses, and not only the top line item 'revenue'. Whether the income related to a customer contract should be presented as 'revenue'

or other components in the income statement, should, in the DIA's opinion, be solved in the coming IFRS on Financial Statement Presentation.

- The measurement proposed for the revenue recognition model is not consistent with the proposals in the DP on insurance contracts (2007) and with the measurement models currently discussed in the insurance project i.e. current exit value and current fulfilment value.
- Many contracts that are financial instruments are characterized by volatility. The transaction price approach used in the proposed revenue recognition model would not provide decision-useful information about those contracts.
- The unit of account in the DP seems to be on individual contract level. Insurance business is based on pooling and managing a portfolio of risks. Estimating the value of contracts when the rights and obligations are contingent on uncertain events may be impossible at an individual contract level; however estimating values for a portfolio of contracts can achieve reliable estimates suitable as a basis for revenue recognition. In particular, the separate identification of onerous performance obligations may not be workable for individual insurance contracts.

Question 3

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

The definition of a contract in the DP is based on the enforceability of rights and obligations under the contract. Some insurance and investment contracts include rights and obligations that are met at the discretion of one of the parties to the contract but create certain expectations for the other party, which are reflected in the overall transaction price.

Evaluating these contracts based solely on the enforceable rights and obligations does not reflect the true economics of these transactions.

Question 4 - 5

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

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?

It is not clear to us how the concept of a performance obligation would apply to an insurance contract. It would be helpful if the boards' would provide an example of the application of the revenue recognition model for a long term life insurance contract. E.g. when should the investment margin (the return on assets measured at fair value with gain and losses through profit and loss, less interest

accumulated on the insurance liability) and the compensation for bearing risk be recognised in the income statement?

For a life insurance contract, the insurance liability (which we assume correspond to the performance obligation) may not be reduced for a long time (up to 30 years) until the start of the payment period, when the entity transfers the promised benefits to the customer. However, in the meantime services e.g. investment services and insurance risk cover may be provided for which fees are being paid. We assume that revenue from services and risk cover delivered on an ongoing basis can also be recognised as revenue on an ongoing basis.

However, as the payment profiles for service and insurance risk cover are different from the payment profile for the deposit element, the proposed revenue recognition model seems to require unbundling of the premium payment in service/risk cover and deposit elements of which the deposit element will first create revenue recognition in the payment period, which could be up to 30 years from contract inception.

Transaction prices for individual components of an insurance contract could only rarely be identified due to the interdependency of the components in the contract. An attempt to unbundle the components will result in arbitrary judgements. The DIA does not believe, that performance obligations for components of insurance contracts should be separately identified, unless those components are clearly not interdependent and their value can be estimated reliably.

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 response.

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?

No response.

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.

We agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or receives

the promised service, but it is difficult to interpret the delivery of a good or service for insurance.

The proposed model in the DP seems to imply that revenue for certain life insurance contracts is not recognised until the contract is paid out i.e. after 30 years when performance obligations decreases. However, the insurer is providing services over the term of the contract. Accordingly, in our view, some revenue should be recognised over the term of the contract consistent with the services provided.

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.

The DIA does not believe that the decision to recognise revenue only when performance obligations are satisfied will provide decision-useful information for insurance contracts.

Insurance contracts are long term contracts with uncertain cash flows. Changes in economic variables such as interest rates (the time value of money) and changes in insurance technical assumptions such as longevity and loss frequencies may affect the value of the insurance liability over the duration of the contract. Such changes are not captured though the locked-in measurement - the transaction price approach - used in the proposed revenue recognition model. The DIA find that such changes in the value of the liability should be recognised in the income statement as well as the changes which define revenue in the DP.

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?
(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?
(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.
(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.

(a) The DIA does not agree that performance obligations for all insurance contracts should be measured initially at the transaction price.

For some insurance contracts there may be substantial acquisition costs. These costs will in many cases be recovered over the duration of the contract. The transaction price will, therefore, include an amount to recover acquisition costs. As the acquisition costs are expensed before or at inception of the contract, they do not relate to the remaining contract obligations.

The measurement of performance obligations (the insurance liability) initially should reflect a current (economic) value of the remaining obligations within the insurance contract.

Within the insurance project several measurement attributes are currently debated, which should be considered.

(b) The DIA do not agree that only performance obligations which are deemed onerous should be remeasured. This measurement will result in an asymmetrical treatment of gains and losses associated with insurance contracts. We do not find this measurement reflects the economic characteristics of insurance contracts.

Further, using the cost trigger for remeasuring onerous contracts will not provide an explicit measurement of the margin but rather the margin will function as a buffer and the resulting measurement may be a measurement at cost without a margin. The DIA are concerned that such a measurement would not reflect the current economic value of the insurance contract.

(c) The DIA does not support the transaction price approach for subsequent measurement of insurance contracts as also indicated in the answer to question 2. As insurance contracts are long term and are characterised by uncertain cash flows, a measurement at the transaction price will not capture the economic characteristics of insurance liabilities very well. This may or may not be the case for other long term contracts.

(d) The DIA would, therefore, prefer a more current measurement model for insurance contracts than the one chosen for the revenue recognition model. Within the insurance project of IASB several measurement models are currently debated. Among these are current exit value and current fulfilment value. The DIA find it important that the measurement of the insurance liability in the balance sheet reflects a current economic value of the insurance liability. We further find it important that it is possible at inception to recognise as revenue the recovery of acquisition costs (see answer to question 11) and other profit elements not related to the liability/performance obligation towards the policyholder.

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 en-

tity 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?

(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.

(a) The DIA does not 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. As the acquisition costs are expensed before or at inception of the contract, the amounts charged to recover these costs do not relate to the remaining contract obligations.

If such amounts are included in the initial measurement of the performance obligations new business will show a loss at inception although it may be profitable from an economic point of view. This will not provide decision-useful information to users of accounts. In order to provide more decision-useful information to users of accounts, insurers may have to provide an embedded value calculation. There is in fact today a demand from e.g. investors for such information that better reflects the value incorporated within new insurance contracts. It would be better if the accounting rules were good enough to provide this information to investors through the financial statements.

(b) We believe that contract origination costs should be expensed provided that part of the contract revenue charged to cover these costs is recognised in profit or loss on inception. This will reflect the economics of insurance contracts.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

The DIA does not find this relevant to insurance contracts; see our answer to question 10.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

The DIA does not find this relevant to insurance contracts; see our answer to question 10.