



**Michael Monahan**  
Director, Accounting Policy  
(202) 624-2324 t (202) 572-4746 f  
mikemonahan@acli.com

June 30, 2009

Mr. Robert H. Herz, Chair  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

Re: File Reference No. 1660-100 -  
Discussion Paper: *Preliminary Views on Revenue Recognition in Contracts with Customers*

Dear Mr. Herz,

The American Council of Life Insurers (ACLI)<sup>1</sup> is pleased to share with you our views regarding the issues related to the Discussion Paper: *Preliminary Views on Revenue Recognition in Contracts with Customers* (DP). The DP presents new concepts and principles to the recognition of revenue that not only will be conceptually significant but has the potential to materially influence decisions about the insurance contracts project. Consequently, we carefully reviewed the DP and developed this response considering conceptual issues along with specific application to insurance.

### **Revenue Recognition Model**

As noted in the DP, there are numerous standards that define revenue and the earnings process that may not be consistent or complete. A single principle-based standard might help to improve financial reporting thereby enhancing the users understanding of the financial condition of the reporting entity. While we believe this joint IASB/FASB project is important in the boards efforts to achieve a single comprehensive set of accounting standards, the DP has many shortcomings that form the basis of our response covering such topics as the definition of revenue, lack of clarity about certain concepts-revenue vs. earnings or profits, and need for guidance about long-duration contracts. The DP appears to focus on short-duration contracts, which makes it difficult to apply certain concepts to more complex contracts especially long-duration insurance contracts. The three-year warranty example attempts to illustrate the application to long-duration contracts but the simplified view masks critical issues such as the time value of money and release from risk. To assist the boards in future deliberations, the illustrations in the attached appendix may be instructive.

The DP does describe certain concepts that we support, which should be foundational to a revenue recognition standard. For example, the revenue recognition principle should be contract based, that is, a relationship with a customer that creates rights and obligations for the parties to the contract. Measurement of contract obligations should be based upon the building blocks described in Appendix B of the DP, which is consistent with the tentative views on the insurance contracts project. There should be no gain at inception or revenue recognized until the parties perform according to the contractual terms. Revenue should be measured consistent with changes in contract assets and/or

---

<sup>1</sup> The American Council of Life Insurers is a trade association with 340 member companies that account for 93 percent of the life insurance industry's total assets in the United States, 94 percent of life insurance premiums and 94 percent of annuity considerations. ACLI member companies are leading providers of retirement and financial security products, including life, disability income, and long-term care insurance; annuities; reinsurance; IRAs; and pensions such as 401(k), 403(b), and 457 plans.

liabilities with the statement of financial condition reporting the net position in a contract. The reporting of the net position is consistent with current accounting guidance for offsetting financial assets and liabilities. However, the statement of comprehensive income should display separately the changes in contract rights and obligations.

### **Definitions of revenue, contract and customer**

The revenue recognition principle described in paragraph 2.35, “*For a contract with a customer, revenue is recognised when a contract asset increases or a contract liability decreases (or some combination of the two)*” is too broad, in our opinion. We do not find this principle to be sufficiently robust to enable users to understand its application especially as it relates to complex contracts such as insurance. While we have no objection to reflecting changes in assets and liabilities (other than transactions with owners) in the Statement of Comprehensive Income, it is unclear to us if the focus is on revenue or earnings. The DP seems to use these two terms interchangeably. However, we do not believe that the terms revenue and earnings are the same. Earnings, in our view, typically equates to net income while revenue reflects the inflows resulting from a transaction with a customer. For insurance contracts, revenue should represent the premiums from the policyholder according to the terms of the contract. In a manufacturing setting, revenues would represent sales arising from transactions with customers. Until there is greater clarity about the revenue objective, we have no alternative definition at this time.

Essential to the understanding of any revenue principle is a clear and concise definition of a contract and customer. We agree with the definition for customer but disagree with the definition of contract. In the ACLI response to the Discussion Paper: *Preliminary Views on Insurance contracts*, we expressed our concern that the definition of an insurance contract should not be constrained by the use of terms such as “enforceable”, “legal”, or “constructive obligation”. In other words, all cash flows arising out of the contract provisions should be taken into account when measuring the obligation.

### **Measurement vs. presentation**

As noted above, we have no objection to reporting the net position in a contract in the statement of financial condition. However, revenue is a component of the income statement (statement of comprehensive income). We believe that any accounting standard on revenue may be as much about presentation as it is about measurement. As it relates to insurance contracts, the contract liabilities relate primarily to the expected benefit payments payable to policyholders and beneficiaries. Any presentation of revenue and benefits that doesn’t reflect the nature of the contract will be misleading and will not provide useful information to the users of financial statements. For example, the allocation of the transaction price over three years in the warranty illustration, while equaling the customer consideration, commingles the contractual rights and obligations. A revenue concept based upon sales would report the customer consideration separately from the entity’s performance obligation. Consequently, any future deliberations on this project should carefully consider the discussions and direction of the Financial Statement Presentation project.

The measurement approach in the DP uses an allocated transaction price applied to the separately identifiable performance obligations. While the DP examples illustrate the application of this approach, we believe the boards should assess the effectiveness of this approach to more complex transactions such as long-duration insurance contracts. As the ACLI has noted in its response on the insurance contracts project, all cash flows associated with the insurance contract should be taken into account in the measurement of the obligation of which the transaction price-premiums is one input. If acquisition costs for insurance contracts are expensed as currently contemplated in the insurance contracts project, then the gross premiums, i.e., customer consideration, should be included in the measurement.

The building blocks approach described in the appendix to the DP is an approach that should be the basis for the revenue project. This approach is consistent with current thinking for insurance contracts, which we support.

The lock-in of assumptions at issue and remeasurement only when the contract is onerous implies a cost model. The ACLI supports an approach that promotes a consistent measurement of assets and liabilities that reflects the nature of the business and avoids/minimizes accounting mismatch. The ability for the reporting entity to select between two measurement approaches, current fulfillment value or cost/amortized cost models, we believe, could achieve this objective. Any revenue standard should not be limiting or propose an approach that differs from the measurement approaches resulting from the Financial Instruments project.

## Summary

The Revenue Recognition project has the potential to improve the consistency and enhance the understanding of the financial statements but considerable work remains. Clearly stated objectives, principles and terminology are critical to the ultimate standard. The building blocks approach, we believe, could serve as foundational for the standard with revenue representing sales, which is consistent with the nature of the business of the reporting entity. The final revenue standard needs to dovetail with the other critical joint projects, specifically, the insurance contracts project, financial instruments project and financial statement presentation project to avoid confusion and conflict.

We welcome the opportunity to discuss our views and expand upon the illustrations contained in Appendix A to this letter. If you have any questions, please do not hesitate to contact me.

Sincerely,

A handwritten signature in cursive script, appearing to read "M. Monahan".

Cc: Jeffrey Cropsey, FASB staff  
Peter Clark, IASB staff  
Hans van der Veen, IASB staff

## Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers

### Chapter 2

#### 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?*

#### Response:

We agree with the Board that a single revenue recognition principle may be appropriate given the fact that various recognition rules exist and inconsistencies are prevalent among industries. However, we have reservations about the revenue principle described in the DP. We do not find it a robust definition nor does the DP articulate the purpose and objectives to be achieved by such a standard. We are also concerned about the recognition of revenue and the allocation process as it might relate to the insurance industry, and have outlined our concerns in Question 2.

#### 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?*

#### Response:

We feel the boards' proposed principle would not provide decision-useful information for some types of insurance contracts. To address those concerns, we feel the guidance needs to consider the following items:

- The DP model focuses on revenue recognition when an increase in assets or a decrease in liabilities occurs. This focus may not be consistent with the current deliberations for insurance contracts. The DP needs to consider insurance contracts that provide risk protection and other services over a period of time. We believe that the insurance company should recognize revenue for providing protection over time (consistent with a release-from-risk approach), not just when an obligation is decreased.
- The model presented in the DP applies best to short term contracts that have no account value. We feel the nature of long term insurance contracts needs to be considered within the guidance. In some cases, the liability does not decrease until the contract is terminated, either by death or surrender. Under the proposed model, the insurance company would recognize revenue upon termination of the contract, when the liability is extinguished. We believe that it would be more appropriate to recognize revenue as protection is provided over the life of the contract, rather than recognizing revenue upon termination.
- The guidance proposes that the measurement of a performance obligation should not be updated unless that performance obligation is deemed onerous. This creates a conflict with the measurement models being considered for the Insurance Contracts project as well as the Financial Instruments project. Under the current fulfillment value approach, the liability measurement would be updated over time to reflect emerging experience and changes in future expectations. For long-duration contracts, we believe that it is appropriate to update the liability measurement over time. The locking in of the assumptions at inception is appropriate for a "cost" model. The ACLI has supported the consistent measurement of assets and liabilities to avoid accounting mismatch. Accounting standards should provide the reporting entity with a choice of measurement attributes that best reflects the nature of the business.

- Below is a simple example that helps to illustrate the concerns that we have outlined above:

Consider the example of a simple deferred annuity contract that is classified as an insurance contract under IFRS 4. The customer pays a \$1,000 premium to ABC insurance company on 1/1/2010, and ABC credits interest to the contract at the rate of 5% per year. Suppose that the customer surrenders the contract 5 years later, on 1/1/2015, at a value of  $\$1,000 * 1.05^5 = \$1,276$ . At 12/31/2014, the contract liability is \$1,276. Upon the termination of the contract on 1/1/2015, the contract liability drops to 0. Based on the model proposed in the DP, no revenue would be recognized until the termination date, when the liability decreases to zero. In this example, we believe that it would be more appropriate to recognize revenue over the life of the contract, rather than recognizing revenue only at the termination date.

### 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.*

#### **Response:**

With regard to the boards' definition of "contract" as stated in the Discussion Paper, we do not agree with the use of the term "enforceable obligations" being used to describe the definition of the contract based on its application to insurance contracts. We consider that the insurer has a stand ready obligation to accept premiums under a contract unless it has the ability to freely re-price those premiums taking into account the current risk profile of the individual policyholder or the contract has formally expired (i.e. there is no remaining contractual obligation by either party). Put a different way, unless the insurer can freely re-price the contract the entity is obligated to accept a premium at a rate which contractually has the potential to differ from that at which it would price a new contract. Such premiums should be considered part of the existing contract. This differs from the definition that is included in the Discussion Paper, which would indicate that a contract must create an enforceable obligation.

We reference discussions that have taken place between the IASB and the insurance industry regarding boundaries of the insurance contract as it relates to policyholder behavior and we believe that discussion is also applicable to the boards' definition of "contract" in the context of this Discussion Paper. We refer to the definition of "contract boundary" suggested by the ACLI and other trade organizations in our joint trade letter submitted to Sir David Tweedie on 18 December 2008 in connection with the IASB's Discussion Paper "Preliminary Views on Insurance Contracts" ("joint trade letter").

In this joint trade letter, we indicated the insurance contract boundary should be determined based on the following criteria:

The boundary of a given contract is defined by the cash in-flows that are expected to fall within the contract's term. For these purposes the term of a contract is the shorter of the contract's life and the point, if any, at which the policy can be freely re-priced by the insurer at the individual policyholder level, (i.e. up until the point at which the insurer has the ability both to reassess the risk profile of the individual policyholder and change the price for an individual without contract constraint.)

We continue to believe these criteria are not only appropriate to determine both the measurement of the liability, but also to determine the recognition of revenue associated with an insurance contract.

We would suggest that the boards revisit this definition and reconsider the use of the term "enforceable obligation" such that a contract could also be defined by the cash in-flows that are

expected to fall within the contract's term. Alternatively, we suggest that the boards clarify that the term "enforceable obligation" should not be interpreted to mean an obligation enforceable by law but rather the obligation could represent a stand ready obligation to accept a premium [revenue] at a rate which contractually has the potential to differ from that at which it would price a new contract.

### Chapter 3

#### Question 4

*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.*

**Response:**

Yes, the definition in the paper would allow entities to consistently define the deliverables in the contract. However, the choices presented in the discussion paper should clarify whether the right of return is a performance obligation.

#### 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?*

**Response:**

No, we believe that performance obligations in a contract, especially for insurance contracts, should not be separated when the contract provisions are interdependent. Furthermore, we believe this allocation is not appropriate for all types of contracts. We think only those performance obligations with identifiable charges should be separated.

We believe that separation of performance obligations in complex contracts would not be appropriate. For example, life insurance contracts have many provisions and options that would make it very difficult to separate performance obligations especially because of their interdependencies. Many life insurance contracts have a right of return period, a surrender option, a policy loan option and in some cases policyholders can opt to stop paying premium in exchange for a lower face amount. We believe that allocating the premium into all these component parts and keeping track of the satisfaction of performance obligations would create an overly complicated recordkeeping exercise that adds little value to users of the financials. Assigning probabilities to insured activity is better covered in the expected cash flows used in the reserves rather than in the revenue recognition.

#### 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?*

**Response:**

The right of return could apply to insurance contracts in two situations:

- Contracts in the underwriting process that are prepaid and effective when the application and funds are received.
- Contracts that have been delivered but are within the "free look" period.

Typically, the insured has a period of time, as much as 30 days in some jurisdictions, where they can rescind the contract and receive a full refund. The DP presents two views: 1) partial revenue recognition with delayed recognition for the amount attributed to the return service (paragraph 3.38), and 2) delayed revenue recognition until the return period expires (paragraph 3.4). Since the insurer is obligated to pay benefits under the terms of the contract when the contract is in the “free look” period, we believe that the return provision is a performance obligation and measured along with any other options and features of the insurance contract.

In addition, there are other components of the contract, e.g., commission expense that would create offsets if the free look provision is exercised. These would be taken into account in determining the net effect for the right of return.

#### **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?*

#### **Response:**

While we believe this concept may not be applicable for insurance, it is unclear whether the term “sales incentive” is intended to be limiting, i.e., future sales, as noted by the example in the question. Statement of Position 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, paragraphs 36 and 37, addresses sales incentives to contract holders. An insurer may offer a higher interest rate in the early years as an incentive to purchase. Since this incentive is part of the contract, it is a performance obligation to be taken into account when measuring the insurance liabilities.

#### **Chapter 4**

#### **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.*

#### **Response**

In our view the asset transferred (risk protection) under an insurance contract meets the definition of a service.

Under IFRS 4, Insurance Contracts, an insurance contract is defined as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. When a policyholder purchases an insurance contract, the insurer accepts risk from the policyholder but does not provide a tangible good in return. Instead, the insurer stands ready to fulfill the contract promises if/when an insured event occurs. The insurer’s readiness/obligation to compensate the policyholder during the coverage period is a continuous transfer of services to the policyholder over the term of the policy. The discussion paper states that a service is a customer’s asset when the customer has received the promised service (4.7, 4.61). Therefore, the insurer satisfies its performance obligation with the passage of time over the period of insurance coverage.

#### **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.

**Response:**

In our response to question 2 we provided an example of a deferred annuity contract, which included an initial deposit that accumulates with interest over time and matures at the end of five years. The performance obligation is not satisfied until the payment is made at maturity of the contract and therefore no revenue is recognized during the term of the contract. This pattern does not provide decision useful information since the related services are performed over the five year term. The costs related to the services could result in a loss during those years unless there is some offsetting provision.

Disability contracts, for example, provide benefit payments for a disability occurring during the period of coverage. While the event may be known, there is uncertainty about the amount and timing of the benefit payments. Also, claims for covered disabilities may not be reported until a later date after the contract term has ended. Benefit payments may also extend beyond the period of coverage and require ongoing revisions to the estimate of the performance obligation. The DP model does not allow for remeasurement unless the contract becomes onerous nor does the DP address complex contracts especially when the amounts payable are uncertain and based upon estimates.

## Chapter 5

### 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?*

**Response:**

At inception, the performance obligation should take into account all elements of the contract of which the transaction price represents one important element. With respect to insurance contracts, as an example, the contractual premiums represent the transaction price-customer consideration. The benefit of using transaction price is that there would be no gain at inception where the parties have yet to perform under the contractual terms.

*(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?*

**Response:**

Remeasurement of a contract when it becomes onerous and the definition of onerous as it relates to insurance contracts should not be part of this project. Remeasurement due to changes in the contract where the expected outcome is a loss is not a revenue generating event. Other accounting standards, e.g., insurance contracts, should provide the guidance about contract losses. A serious shortcoming in the DP is that it implies that additional revenue could result when a contract is onerous when in fact it is a loss.

The onerous test as described in the DP may work for non-insurance contracts. The notion of onerous contracts for insurance continues to be debated. Insurers don't and can't distinguish between healthy and unhealthy insureds after issue of the contract. The measurement of insurance contract liabilities is a portfolio approach whereby the entity can determine if the experience of a portfolio of contracts materially differs from the original assumptions. Material changes can occur for reasons other than health, such as is the case with lapses. Material changes likewise can result from unexpected or accidental deaths. For example, the 2005 edition of the U.S. National Center for Health Statistics reports that over half of the deaths of individuals between the ages of 25-34 were caused by accidents, compared to a 31 percent rate of accidental deaths for individuals between the ages of 35-44. Therefore, the insurance contracts project is the appropriate place to provide guidance when a contract becomes onerous.

The DP prescribes one measurement approach, which appears to be a cost model because of the lock-in of assumptions at issue. The joint project on financial instruments is moving toward simplifying the measurement choices to fair value and amortized cost. The final revenue recognition standard needs to dovetail with the boards decisions on the financial instruments project. The ACLI has expressed the view for consistent measurement of assets and liabilities.

*(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.*

**Response:**

The ACLI believes that the DP does not adequately address long-duration contracts, the inputs to the measurement at inception and the effects of changes from original assumptions in subsequent periods as well as the display in the statement of comprehensive income. To assist the boards in this regard, the illustrations in the appendix are intended to highlight critical issues requiring further deliberations and our views about these issues.

*(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.*

**Response:**

As noted above, the DP seems to be a cost approach, which should not be discarded since it would serve as an appropriate measurement for many contracts especially short-duration contracts. If the boards move toward adding a fair value measurement approach, we urge caution that the measurement of the obligations should not be based solely upon an exit price since contracts with customers are not typically traded. The "fulfillment approach" under consideration for insurance contracts is one we support as relevant for contracts with customers.

**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 (e.g., 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?

**Response:**

As noted previously, all cash flows associated with the terms of the contract should be taken into account at inception. Excluding certain amounts would generate losses at issue upon the sale of profitable contracts. The measurement of performance obligations for insurance contracts should be based upon the contractually specified premiums. If acquisition costs (i.e. those costs that vary with and are primarily related to the origination of the contract) are expensed without appropriate recognition of the premiums, not only will this cause a loss at issue but more importantly would not be a faithful representation of the contract.

The premiums include an element related to acquisition costs incurred by the insurance company. However, that does not mean that the expected future premiums to be paid should be excluded from the measurement of the contract.

*(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.*

**Response:**

The ACLI has expressed the view that we have no objection to expensing acquisition costs for insurance contracts provided there are no artificial constraints on the premiums to be used in measuring the performance obligation. Imposing such constraints would not provide decision-useful information as this generates losses upon the sale of profitable 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?*

**Response:**

Only if clearly separable and the value is easily determinable (i.e. if the services are priced separately). If not clearly separable, then the performance obligation should include the present value of cash flows for the goods and services associated with the insurance contract.

**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.*

**Response:**

Further deliberation is needed since the issue is not whether the good or service is provided by the entity but whether the separation or bifurcation of the contract is appropriate. The ACLI has expressed the view that because of the interrelationship of elements of an insurance contract, unbundling should not be required. Measurement of insurance contracts should be based upon

the measurement of the combined rights and obligations under the contracts unless the individual components are clearly separable and unrelated.

## Appendix A

### Comparison of Contracts Using the DP or Insurance Presentation Model

The objective of this Appendix is to evaluate the Warranty illustration as described in the DP (paragraphs B12-B25) using a “Building Blocks” approach. To facilitate discussion and clearly understand critical issues about this approach, a five-year term contract is included in the analysis.

The warranty example presented herein has been slightly modified to further simplify it by assuming the actual pattern of claims is the same as projected, i.e., 5%, 5%, and 10% in years 1, 2 and 3 respectively. Changes in assumptions and how the results would be presented in the financial statements will be addressed separately.

Because the warranty example assumes that the customer consideration is a lump sum payment and did not reflect the effects of the time value of money, a five-year term contract was developed to illustrate the effects when the customer consideration occurs over a period of time, i.e., five years, and the measurement takes into account the time value of money. This example builds on the one contained in the ACLI June 3, 2009 letter to the IASB regarding Staff Papers on Insurance Contracts, April 2009-Margins.

Two observations are noteworthy about the warranty example as illustrated. First, **revenue is a result of an allocation process**. In this case, revenue is a function of the change in the performance obligation between periods with the margin released in a similar manner. Second, as a result of allocating the customer consideration over multiple periods, **users of the financial statements could conclude that there were sales in periods two and three** when in fact, the sale occurred in year one.

The allocation process reports revenue in years two and three based upon the change in the liability, arguably representing the release from risk. While we do not support this allocation approach, we question whether the liability, in this case, is the appropriate allocation basis. The potential maximum exposure at inception is \$20,500 (20 x [\$1,000 per claim + \$25 expense per claim]) assuming all 20 contracts were to result in a claim. At the beginning of the third year, the maximum exposure is 18 claims assuming actual equals expected. Should the allocation be a function of the maximum claim exposure or the expected claims? A different revenue amount results depending on the allocation method selected. Regardless of the allocation method, the result will tend to back-end revenue as evidenced by this illustration.

Representing the warranty example (Warranty Example-Insurance Format) in the context of an insurance contract, e.g., single premium life annuity, the following observations can be made. Revenue would reflect the sales in the period it occurs with the liability, representing the outstanding performance obligation, separately reported. While one could argue that revenue under this format seems more like a cash flow approach, it highlights the issue about the purpose and objective of revenue as well as issues about display. For example, under the insurance format, if revenue represented sales, which reflects the nature of the business, with the change in the performance obligation separately displayed, the resulting presentation, we believe, provides users with a faithful representation of the business. The question is whether users would benefit from a gross presentation, i.e., insurance format, or a net presentation-DP format?

The five-year term example provides a slightly more complicated scenario that highlights issues that we believe require further deliberations. For example, under the DP format, revenue in year one of \$10,046,352 exceeds the actual customer consideration in year one of \$8,000,000. The

revenue in years 2-5 in the DP version increases using the allocation method, which represents the change in the performance obligation. The total revenue in both examples is \$35,063,987 (customer consideration) but the insurance format reflects the consideration consistent with the policyholders' payment obligation.

Unlike the simple warranty example where the difference between revenue and expenses equals the margin, this is not the case in the term example because of the time value of money. Hence, we labeled the difference between revenue and expenses as "Net insurance income". The difference between net insurance income and the undiscounted margin that would emerge each period is the interest on the entire net outstanding liability, i.e., benefits, expenses, margins and premiums. This reconciliation of the difference appears at the end of the insurance example.

Consequently, we believe the boards need to have further deliberations about the following:

- Does the revenue principle as described in paragraph 2.35 appropriately and clearly describe the objective of revenue recognition? For example, should revenue be a sales model or something else; an allocation process or one that reflects the nature of the business?
- What level of disaggregation should there be about revenue, e.g., gross vs. net presentation? This discussion needs to be in conjunction with the Performance Reporting project.
- Should the "margins" equate in some way to profits or is it a result, the difference between sales and cost of sales, which is the typical presentation in a manufacturing setting analogous to "gross margin"?
- How should the time value of money be represented in the financial statements?

Warranty Example (DP Format)

(Assumes actual = expected)

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Assets	-	8,500	7,000	4,500
Liabilities:				
-PV of obligation	4,000	3,000	2,000	-
-PV of expenses	1,500	1,000	500	-
-PV of considerations	(10,000)	-	-	-
-Margins	<u>4,500</u>	<u>3,273</u>	<u>2,045</u>	<u>-</u>
	-	7,273	4,545	-
Surplus	-	1,227	2,455	4,500
Revenue		2,727	2,727	4,545
Benefits		1,000	1,000	2,000
Expenses		<u>500</u>	<u>500</u>	<u>500</u>
Total benefits & expense		1,500	1,500	2,500
Margin		1,227	1,227	2,045

Warranty Example-(Insurance Format)

(Assumes actual = expected)

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Assets	-	8,500	7,000	4,500
Liabilities:				
-PV of obligation	4,000	3,000	2,000	-
-PV of expenses	1,500	1,000	500	-
-PV of premiums	(10,000)	-	-	-
-Margins	<u>4,500</u>	<u>3,273</u>	<u>2,045</u>	<u>-</u>
	-	7,273	4,545	-
Surplus	-	1,227	2,455	4,500
Revenue-Premiums		10,000	-	-
Benefits		1,000	1,000	2,000
Expenses		<u>500</u>	<u>500</u>	<u>500</u>
Total benefits & expense		1,500	1,500	2,500
Change in liability		<u>7,273</u>	<u>(2,727)</u>	<u>(4,545)</u>
Margin		1,227	1,227	2,045

**Five Year Term Contract**

Assumptions	1	2	3	4	5
Mortality rate	0.000300	0.000442	0.000584	0.000726	0.000868
Lapse rate (lapses at end of policy yr)	8.00%	6.00%	5.00%	5.00%	5.00%
Policies in force, beginning of year	10,000.0	9,197.0	8,641.1	8,204.0	7,787.9
Number of claims	3.000	4.065	5.046	5.956	6.760
Number of lapses	800.0	551.8	432.1	410.2	7,781.1
Expenses as % of premium	80.0%	5.0%	5.0%	5.0%	5.0%
Expenses per claim	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Face amount of insurance per policy	1,000,000				
Annual premium per policy	\$ 800.00				

Expected cash flows undiscounted	1	2	3	4	5
Premiums paid (beg of yr)	8,000,000	7,357,600	6,912,892	6,563,210	6,230,285
Expenses paid (beg of yr)	6,400,000	367,880	345,645	328,161	311,514
Claims paid (end of yr)	3,000,000	4,065,074	5,046,411	5,956,113	6,759,859
Expenses paid (end of yr)	80,000	55,182	43,206	41,020	778,110
Margins (end of yr)	646,363	648,381	618,537	558,003	465,561

Present value of cash flows (all as of the beginning of the year)	1	2	3	4	5
Premiums paid	32,072,653	25,276,286	18,814,620	12,496,815	6,230,285
Total expenses	8,410,614	2,031,145	1,691,246	1,369,676	1,052,571
Claims	21,100,200	19,155,210	16,047,897	11,803,880	6,437,961
Margins	2,561,839	2,043,580	1,497,377	953,709	443,392
Best-estimate liability (beg of yr)	(2,561,839)	(4,089,931)	(1,075,478)	676,741	1,260,247
Liability margin added (beg of yr)	2,561,839	2,043,580	1,497,377	953,709	443,392
Financial statement liability (beg of yr)	0	(2,046,352)	421,899	1,630,451	1,703,639

Term Insurance Contract Example-(DP Format)

(Assumes actual = expected)

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Assets	-	(1,480,000)	1,389,464	2,867,095	3,105,011	1,485,813
Liabilities:						
-PV of obligation	21,100,200	19,155,210	16,047,897	11,803,880	6,437,961	
-PV of expenses	8,410,614	2,031,145	1,691,246	1,369,676	1,052,571	
-PV of premiums	(32,072,653)	(25,276,286)	(18,814,620)	(12,496,815)	(6,230,285)	
-Margins	<u>2,561,839</u>	<u>2,043,580</u>	<u>1,497,377</u>	<u>953,709</u>	<u>443,392</u>	<u>-</u>
	0	(2,046,352)	421,899	1,630,451	1,703,639	-
Surplus	(0)	566,352	967,565	1,236,644	1,401,372	1,485,813
Revenue		10,046,352	4,889,349	5,704,341	6,490,022	7,933,924
Benefits		3,000,000	4,065,074	5,046,411	5,956,113	6,759,859
Expenses		6,400,000	367,880	345,645	328,161	311,514
Claims expenses		<u>80,000</u>	<u>55,182</u>	<u>43,206</u>	<u>41,020</u>	<u>778,110</u>
Total benefits & expense		9,480,000	4,488,136	5,435,261	6,325,294	7,849,483
Net insurance income		566,352	401,213	269,080	164,728	84,441

Term Insurance Contract Example-(Insurance Format)

(Assumes actual = expected)

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Assets	-	(1,480,000)	1,389,464	2,867,095	3,105,011	1,485,813
Liabilities:						
-PV of obligation	21,100,200	19,155,210	16,047,897	11,803,880	6,437,961	
-PV of expenses	8,410,614	2,031,145	1,691,246	1,369,676	1,052,571	
-PV of premiums	(32,072,653)	(25,276,286)	(18,814,620)	(12,496,815)	(6,230,285)	
-Margins	<u>2,561,839</u>	<u>2,043,580</u>	<u>1,497,377</u>	<u>953,709</u>	<u>443,392</u>	<u>-</u>
	0	(2,046,352)	421,899	1,630,451	1,703,639	-
Surplus	(0)	566,352	967,565	1,236,644	1,401,372	1,485,813
Revenue-Premiums		8,000,000	7,357,600	6,912,892	6,563,210	6,230,285
Benefits		3,000,000	4,065,074	5,046,411	5,956,113	6,759,859
Expenses		6,400,000	367,880	345,645	328,161	311,514
Claims expenses		<u>80,000</u>	<u>55,182</u>	<u>43,206</u>	<u>41,020</u>	<u>778,110</u>
Total benefits & expense		9,480,000	4,488,136	5,435,261	6,325,294	7,849,483
Change in liability		(2,046,352)	2,468,251	1,208,551	73,188	(1,703,639)
Net insurance income		566,352	401,213	269,080	164,728	84,441

Reconciliation of gross margins to net insurance income

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Margins	646,363	648,381	618,537	558,003	465,561
Net interest expense on liability	<u>80,012</u>	<u>247,168</u>	<u>349,457</u>	<u>393,275</u>	<u>381,120</u>
Net insurance income	566,351	401,213	269,080	164,728	84,441