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International
Accounting Standards
Board

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INFORMATION FOR OBSERVERS

Board Meeting: **February 2006, London**

Project: **Insurance contracts (phase II)**
Contractual cash flows that depend on policyholder behaviour
This note covers agenda papers 10A, 10B and 10C

AGENDA PAPER 10A
Contractual cash flows that depend on policyholder behaviour - example

Purpose of this paper

1. This paper uses a simple example to explain why policyholder cancellation options can cause accounting issues even if the insurer:

   (a) incurs no acquisition costs.

   (b) recognises no profit at inception of the contract.

Background

2. An insurer issues 10,000 two-year term life insurance contracts on 1/1/X1 as follows:

   (a) Annual premium of CU 575.80 payable on 1 January. This pricing produces a break even result at the end of X2 if actual experience is in line with the estimates.

   (b) Death benefit of CU 10,000 for deaths between 1/1X1 and 31/12/X2, paid on 31/12 of the year of death. No benefit is paid to survivors.

(c) If the policyholder does not pay the premium due on 1/1X2, the policy lapses at that date: no surrender value is paid and no death benefit is paid for deaths in X2.

(d) On 1/1X1, all policyholders are healthy. The insurer expects that 10% of policyholders will become unhealthy at the end of X1. The insurer does not know their identity and cannot reprice their contracts.

(e) Estimated annual mortality rates are 5% for healthy policyholders and 20% for unhealthy policyholders.

(f) Estimated lapse rates at the end of X1 are 10% for healthy policyholders and 1% for unhealthy policyholders.

(g) For simplicity, the example ignores the time value of money. It also assumes that the insurer does not require a margin for risk or profit, and incurs no acquisition costs or running costs. Although these would be features of a more realistic example, they are not relevant to the topic under discussion and would complicate the example unnecessarily.

3. The following table shows the number of policyholders if actual experience is in line with estimates.

Number of policyholders

	healthy	*unhealthy*	*total*
At 1/1/X1	10,000	0	10,000
Deaths X1	(500)		(500)
Transfer to unhealthy	(950)	950	0
End of X1 (before lapses)	8,550	950	9,500
Lapses end of X1	(855)	(10)	(865)
End of X1 (after lapses)	7,695	940	8,635
Deaths X2	(385)	(188)	(573)
End of X2	7,310	752	8,062

4. The following table shows the cash flows if actual experience is in line with estimates.

Cash flows	*'000*	*'000*	*'000*
	healthy	*unhealthy*	*total*
Premiums 1/1/X1	5,758	0	5,758
Death benefits 31/12/X1	(5,000)		(5,000)
Cash 31/12/X1	758	0	758
Premiums 1/1/X2	4,431	541	4,972
Death benefits 31/12/X2	(3,850)	(1,880)	(5,730)
Cash end of X2	1,339	(1,339)	0

Possible accounting treatments

5. The following table shows how the insurer's balance sheet might look under each of four approaches to the policyholders' cancellation options.

Balance sheet end of X1	exclude all future premiums	healthy and unhealthy	unhealthy only	unhealthy (no lapse)
	'000	*'000*	*'000*	*'000*
Cash	758	758	758	758
Net future cash inflows from healthy		581		
Net future cash outflows to unhealthy		(1,339)	(1,339)	(1,353)
Equity	758	0	(581)	(595)

6. Descriptions follow of the four approaches:

   (a) The first approach excludes all future premiums, and death benefits that result from those premiums. The insurer recognises the cash received (CU 758) and no other asset or liability.

(i) Comment: this approach is clearly untenable, because the insurer has a (contractual) stand ready obligation to accept premiums on 1/1X2.

(b) The second approach includes all the future cash flows that result from the contractual rights and obligations.

(i) Comment: the insurer recognises the cash of CU 758 and a net liability of CU 758 in relation to both healthy and unhealthy policyholders (contractual cash inflows of CU 581 and contractual cash outflows of CU 1,339). The resulting of equity of zero is consistent with the pricing for zero gain and zero loss (remember this example excludes the time value of money and risk margins).

(c) The third approach includes future net cash outflows from unhealthy customers but excludes future net cash inflows from healthy customers.

(i) Comment: this approach reflects the fact that the insurer cannot compel healthy policyholders to pay premiums on 1/1/X2. However, it ignores the fact that the pricing of the contract relies on implicit cross-subsidies from healthy policyholders to policyholders who become unhealthy. It also means that the insurer will recognise negative equity of CU 581 at 31/12/X1, even though it expects the contract to break even. Moreover, it implies that healthy policyholders are 'irrational' if they continue paying premiums, even though this line of thinking implies that all policyholders were acting 'irrationally' in buying the contract in the first place (all policyholders were healthy at inception and so, on average, expect to cross-subsidise those who will become unhealthy).

(d) The fourth approach extends the third approach because the future net cash outflows include, in addition, those from the unhealthy policyholders who will surrender their contracts on 1/1/X2.

(i) This approach is the ultimate logical extension of the third approach. The unhealthy policyholders who surrender (estimated to be 10, of whom 2 are expected to die) appear to be acting irrationally. Moreover, the insurer cannot compel them to surrender. However, this approach means that the insurer would recognise expenses that it does not expect to incur.

Overall comments

7. In this example, only the second approach (include all contractual cash flows from both healthy and unhealthy policyholders) is consistent with the pricing of the contract. It is doubtful whether the other approaches would provide useful information to users.

8. The second approach implicitly relies on net cash inflows from healthy policyholders to subsidise net cash outflows to unhealthy policyholders.

9. The contractual rights and obligations arise at the level of individual contracts and do not change their character by being aggregated into a portfolio. Therefore, the existence of a portfolio is not relevant to determining whether an asset exists (though it might affect the reliability of measurements).

10. Although contractual rights and obligations arise from individual contracts, that need not preclude a portfolio measurement, provided that the rights and obligations arising from each individual contract within the portfolio qualify for recognition as an asset or liability.

AGENDA PAPER 10B
Contractual cash flows that depend on policyholder behaviour

Purpose of this paper

1. This paper discusses whether the measurement of insurance liabilities should reflect expectations of beneficial policyholder behaviour.

2. In this paper:

   a. **beneficial policyholder behaviour** refers to a policyholder exercising a contractual right in a way that is beneficial to the insurer.

   b. **unfavourable policyholder behaviour** refers to a policyholder exercising a contractual right in a way that is unfavourable to the insurer.

3. Agenda paper 10C applies the analysis in this paper to contracts other than insurance contracts.

Summary of recommendations

4. This paper recommends the following:

   a. An insurer's contractual right to benefit from an existing insurance contract would typically qualify for recognition as an asset (paragraph 23).

   b. That right is best viewed as a right to benefit from an existing contract, not as part of right to benefit from an existing customer relationship (paragraph 28).

   c. A right to benefit from a contract with one policyholder might reduce another obligation to the same policyholder. It does not reduce or eliminate a contractual obligation to another policyholder, but the staff should investigate whether some aggregation might be acceptable on cost-benefit grounds (paragraph 29).

   d. An insurer should not recognise purported rights and obligations that lack commercial substance (ie have no discernible effect on the economics of the contract because they do not modify significantly the risk, amount or timing of the cash flows from the contract) (paragraph 36).

e. Contractual rights and contractual obligations include the effect of terms that the legislative or regulatory (and, perhaps, tax) environment imports into the contract. They might (subject to further investigation) also include constructive obligations that build on the explicit obligations stated in the contract (paragraphs 38-40).

f. The staff should investigate whether an insurer should present or disclose its contractual right to benefit from an existing contract separately from its other rights and obligations.

Background

5. For many insurance contracts, cash flows depend on whether policyholders exercise contractual options. For example, policyholders often have a contractual right to cancel a contract. In some cases, early cancellation is unfavourable to the insurer. In other cases, early cancellation is beneficial to the insurer. Cancellation may be unfavourable at some stages of the contract and beneficial at other stages.

6. Cancellation options may be viewed as either a longer contract with an option to cancel, or a shorter contract with an option to continue. Although one description or the other is often more natural in a specific context, this paper treats these descriptions as equivalent.

7. For simplicity, this paper concentrates on cancellation and continuation options. Similar considerations are relevant for other options held by policyholders, including options:

    a. to convert one type of contract into another

    b. to add additional contract elements (‘riders’)

    c. to pay an additional premium to reinstate cover for the remainder of the original contract term after an insured event

    d. to keep a contract in force without paying further premiums, in exchange for reduced benefits (eg making the contract ‘paid up’)

8. The rest of this paper discusses the following topics:

    a. Unfavourable policyholder behaviour (paragraphs 9-12)

b. Beneficial policyholder behaviour (paragraphs 13-16)

c. Recognition as an asset:

  i. Is there a recognisable asset (paragraphs 17-26)?

  ii. If there is a recognisable asset, what is its nature (paragraphs 27-28)?

d. Reduction in the carrying amount of a liability (paragraph 29)

e. Boundaries of the existing contract (paragraphs 30-40)

f. Application in particular cases (paragraph 41)

g. Questions for the Board (paragraph 42).

Unfavourable policyholder behaviour

9. Cancellation is unfavourable to the insurer (and continuation is beneficial to the insurer) if cancellation causes the insurer:

   a. to pay additional benefits (eg a surrender value) whose present value exceeds the present value of the benefits that would otherwise have been payable.

   b. to lose the benefit of cash inflows (eg future premiums or future fees) that it would have received if the contract had continued.

10. An insurer has a contractual stand-ready obligation to pay any additional benefits that result from cancellation (eg a surrender value). Furthermore, if continuation would be unfavourable, the insurer has a stand-ready obligation to pay the additional (net) benefits that result from continuation.

11. Similarly, if cancellation would eliminate future cash inflows (such as future premiums or future fees), the possibility of cancellation reduces the benefit to the insurer of the insurer's right to those cash inflows. The result should be a reduction in the carrying amount of those rights (if they are recognised as a separate asset), or an increase in the carrying amount of the insurance liability (if those rights affect the measurement of the liability).

12. Because of the insurer's stand-ready obligation, it is not difficult to reach the conclusion that the possibility of unfavourable policyholder behaviour should always affect the measurement of the insurer's contractual rights and contractual obligations. Therefore, the rest of this paper concentrates on how an insurer should account for its right to benefit from beneficial policyholder behaviour within the context of the contract.

Beneficial policyholder behaviour

13. Cancellation is beneficial to the insurer (and continuation is unfavourable) if any resulting surrender value is less than the present value of the benefits eliminated by cancellation. This could occur if, for example:

    a. the surrender value includes an explicit or implicit fee levied on the policyholder (a surrender charge).

    b. there has been a significant increase in the probability of the insured event since the contract was underwritten (eg a significant deterioration in the health of the policyholder of a life insurer contract).

14. The Board held a preliminary discussion of beneficial policyholder behaviour in December and noted the following, but was not asked to reach a conclusion:

    a. A long duration contract containing a policyholder option to cancel may be indistinguishable from a short-term contract with similar economic terms containing a policyholder option to renew. Selecting one of these descriptions should not alter the accounting treatment.

    b. The definition of an asset refers to the existence of a resource controlled by the entity. Although the insurer does not control the behaviour of policyholders, it does control its contractual rights. In particular, it can exclude other parties from gaining access to the economic benefits that flow from those rights.

    c. Estimates of policyholder behaviour affect the pricing of a contract, as well as the price negotiated for a business combination or for a portfolio transfer.

    d. The accounting should not reflect contractual rights that lack commercial substance (ie have no discernible effect on the economics of the contract).

e. Some existing accounting models defer costs incurred in originating life insurance contracts (acquisition costs). Some might view such deferrals as a proxy for recognising the insurer's contractual rights. However, the existing description (deferred acquisition costs) and the measurement might not be a faithful representation of those rights.

Accounting for beneficial policyholder behaviour

15. An accounting model might recognise the effect of beneficial policyholder behaviour by either:

    a. recognising the related portion of the insurer's contractual rights to the incremental cash flows as a separate asset, or

    b. reducing the carrying amount of the insurer's other obligations arising from the contract.

16. Initially, this paper considers whether the criteria for recognition as an asset are met. Paragraph 29 considers whether it would be appropriate to reduce the carrying amount of the insurance liability.

Recognition as an asset

17. The Framework defines an asset as 'a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise'.

18. In December 2005, the Board discussed the following working definition of an asset, as part of the project on the conceptual framework: 'An asset of an entity is a present right, or other access, to an existing economic resource with the ability to generate economic benefits to the entity.' The Board noted the need to consider this definition together with recognition criteria to determine what assets are recognised in financial statements.

19. In agenda paper 9 for this [February] meeting, the concepts team proposes a refinement of the working definition discussed in December: 'An asset of an entity is:

    a. cash held by the entity;

b. a present right of the entity to cash; or

c. a present right, or other present privilege, of the entity to a resource that is capable of generating economic benefits to the entity, either directly or indirectly.'

20. To explore the implications of these definitions, consider again the example in agenda paper 10A. At the end of X1, healthy policyholders have the contractual right to obtain life cover for X2 by paying an additional premium of CU 576 on 1/1/X2. The insurer has a corresponding stand ready obligation (the obligation to stand ready to provide that cover on receipt of the premium). Nevertheless, the insurer expects to benefit if healthy policyholders exercise their contractual right to buy cover for X2. The key questions to answer are the following in the context of the current definition:

a. Does the insurer control a resource as a result of a past event (see paragraphs 21-23)?

b. Are future economic benefits expected to flow to the insurer from that resource? In the example, the answer to this question is clearly yes, and this paper does not discuss this point further.

c. If the answer to (a) and (b) is yes, does the asset meet the Framework's recognition criteria? In other words:

   i. Is it probable that the future economic benefits will flow to the insurer? In the example, the answer is clearly yes. This paper does not discuss this point further.

   ii. Does the asset have a cost or value that can be measured reliably? The staff does not expect this to be problematic. Therefore, this paper does not discuss this point further.

Existing control of a resource

21. Applying the current definition, some note that the insurer cannot compel healthy policyholders to pay the premium due on 1/1/X2. Therefore, they argue that the insurer does not control a resource at 31/12/X1. However, the insurer does control its right to benefit from the existing contract. It has the unilateral and unfettered ability to deny other parties access to the economic benefits that flow from those rights.

22. The definition of an asset requires an entity to control an asset as a result of a past event. For contractual rights, the requisite past event is the act of becoming a party to the contract.

23. The staff concludes that:

a. the insurer controls a resource as a result of a past event (existing definition of an asset). The resource is the right to benefit from an existing contract. Moreover, although it may not be certain that the contract will generate net cash inflows, the right itself is unconditional.

b. the insurer has a present right, or other access (or privilege), to an existing economic resource with the ability to generate economic benefits to the insurer (new working definition).

c. the insurer's right to benefit from an existing contract arises from the contract itself. It does not depend on the existence of a portfolio.

d. although the insurer may have incurred acquisition costs, that fact does not in itself create a right to benefit from an existing contract.

Does the policyholder have a liability? If not, can the insurer have an asset?

24. The insurer cannot oblige the policyholder to exercise contractual rights in a way that is beneficial to the insurer. Therefore, an option held by the policyholder does not create a liability for the policyholder. Nevertheless, that does not mean that the insurer has no asset. The insurer's right is not the right to compel the policyholder to act in a way that is beneficial to the insurer. Such a right would, of course, exist only if the policyholder had a corresponding obligation to act in that way. Instead, the relevant right is the insurer's right to benefit from an existing contract. That right is not accompanied by an obligation on the part of the policyholder.

Is the possibility of a market transfer relevant?

25. Insurers sometimes transfer to other parties the benefits arising from rights to future cash inflows from policyholders. For example:

a. a reinsurance transaction may pass through to the reinsurer a portion of all premiums received (and a portion of all claims paid).

b. in a few transactions, insurers have securitised future cash flows associated with insurance contracts. In a life insurance context, these transactions have varying descriptions, often derived from particular features of the insurer's accounting framework (for example, securitisation of in force business, closed block securitisation, embedded value securitisation, securitisation of deferred acquisition costs (!), securitisation of excess statutory reserves - ie regulatory liability measurements that some market participants view as excessive).

c. an insurer may sell its renewal rights when wants to leave a line of business.

26. Some argue that the existence of a market (albeit limited) proves that an asset exists. However, it may be hard to tell whether, for example, a securitisation transaction transfers a right that already exists, or merely creates a new obligation to pass through benefits to be received from rights that may exist in the future. The existence of a market does not, by itself, answer that question. The staff concludes that the possibility of a market transfer is neither necessary, nor sufficient, for the rights under discussion to meet the definition of an asset.

Nature of the asset

27. The following paragraphs discuss whether the insurer's right to benefit from a contract is best viewed as a right to benefit from an existing contract or as part of a right to benefit from an existing customer relationship. That distinction may be important because customer relationships are within the scope of IAS 38 *Intangible Asset*s. Under IAS 38, customer contracts and related customer relationships acquired in a business combination or other external transaction typically qualify for recognition as an asset, but internally generated customer relationships do not. (For contracts distributed through intermediaries, it may be debatable how to determine whether customer relationships are generated internally or acquired externally.)

28. Reverting to our example, 'customer relationship' does not seem to represent faithfully the nature of the insurer's right (at 31/12/X1) to the future net benefits from contracts with healthy policyholders, for the following reasons:

a. The potential cash flows are defined in the existing contract. Those cash flows are only a narrow subset of all cash flows that can be expected from existing customer relationships (which would include repeat sales and cross-selling). If the relationship between insurer and policyholder extends beyond the existing contract, that relationship may affect the probability of lapse, but the primary determinants are the contract itself and the policyholder's needs and preferences, not the broader customer relationship.

b. Neither the insurer nor the policyholder is likely to think of the contract as a one year contract with an option to extend for a further year. They are more likely to view it as a two year contract, with an option to cancel that may become useful if the policyholder's circumstances change. Logically, the two descriptions are equivalent, but psychologically and presentationally they are not. At inception, the policyholder probably expected to keep the contract throughout its full term: buying a long-term contract and then cancelling is not generally a cost-effective way to buy short-term cover. If an accounting model treats the existing contract as terminating at the earliest possible opportunity, that model is unlikely to be a faithful representation of what both parties view as the substance of the contract.

Reduction in the carrying amount of a liability

29. The discussion so far has focused on whether the insurer's contractual rights are a recognisable asset. Another area to explore is whether those rights justify a reduction in the carrying amount of the insurer's contractual obligations, rather than the recognition of a separate asset. There are two cases to consider;

a. whether a right to benefit from a contract with one policyholder might reduce or eliminate a contractual obligation to **another** policyholder. In the example in agenda paper 10A, the insurer has a right to benefit from contractually specified net cash inflows from healthy policyholders, but those rights do not reduce the insurer's net contractual obligations towards unhealthy policyholders. Moreover, normal offsetting criteria are not met. Thus, in this case, there is no conceptual justification for presenting the right to benefit from some existing contracts as a deduction in measuring the contractual obligations arising under other contracts. (We will consider at a later date whether some aggregation might be acceptable on cost-benefit grounds)

b. whether rights to benefit from an existing contract might reduce another obligation to the **same** policyholder. In the example in agenda paper 10A, there are 950 unhealthy policyholders at the end of X1. Of those 950, 10 are expected not to pay the premium due on 1/1/X2 and 2 of those 10 are expected to die in X2. The insurer has the contractual right to benefit from beneficial lapses.[1] Although the insurer does not, at the end of X1, know the identities of the 10 unhealthy policyholders it expects to lapse, those lapses will reduce the net obligation to those 10 (unidentified) individuals. It seems appropriate to measure the insurer's stand ready obligation to unhealthy policyholders on the basis of the (expected) 940 policyholders after lapses, rather than a liability based on 950 (known) policyholders and an asset based on 10 (expected) lapses.

Boundaries of the existing contract

30. This paper argues that the insurer's right to benefit from an existing contract is a recognisable asset. However, it is sometimes difficult to determine where an existing contract ends and where a possible new contract begins. Mere words on a piece of paper cannot be enough.

31. To see this, consider a one year household insurance contract. A measurement of this contract based on estimates of future cash flows would consider only those cash flows that arise from this year's contract, and would ignore cash flows that may arise if the insurer and policyholder agree to renew the contract next year. However, suppose the insurer changes the standard form of its contracts to lifetime contracts, from which both policyholder and insurer are free to withdraw on any anniversary of the original contract date. This apparent contractual change creates no new substantive rights or obligations. Therefore, it should not affect the accounting.

32. It follows that some criterion is needed to ensure that contractual rights refer only to those cash flows that arise from contractual terms that create substantive rights or obligations. Contractual wording should be ignored to the extent that it purports to create rights and obligations that exist only on paper.

[1] ie beneficial to the insurer

33. In July 2005, the staff suggested to the Insurance Working Group that ‘the features unique to insurance contracts are the guaranteed insurability option and the economic benefit to the policyholder resulting from the ability to renew at a market-average price. Thus, a possible criterion for recognition of future premiums could be that cash flows from future renewals should be recognised to the extent that:

    a. the cash flows would be required to permit the policyholder to retain the right to guaranteed insurability; and
    b. the right to guaranteed insurability includes the right to renew without reconfirming the risk profile of the policyholder.’

34. In the staff’s view, that criterion would provide a representationally faithful answer for insurance contracts (including the example in agenda paper 10A). However, in the staff’s view, that criterion is unsatisfactory in two respects:

    a. It is too focused on something specific to insurance, rather than on factors that could be relevant for other types of contract. In other words, although it is a based on a principle, the principle is unnecessarily narrow and could be made more generic.

    b. By relying exclusively on the insurer’s stand ready obligation (to provide guaranteed insurability), the criterion may appear paradoxical: the insurer can recognise a right to benefit from an existing contract only if that contract imposes an additional obligation on the insurer.

35. IFRSs refer in various places to notions such as commercial substance, economic substance or substance and economic reality:

    a. IAS 16 refers in paragraphs 24 and 25 to exchange transactions that lack **commercial substance** (and IAS 38 *Intangible Assets* includes similar material). Paragraph 25 states: ‘An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.'

b. In IAS 39, an embedded derivative is not sufficient to permit an entity to use the fair value option if the derivative 'does not **significantly modify the cash flows** that otherwise would be required by the contract'.

c. In IFRS 4's guidance on the definition of an insurance contract, paragraph B23 notes that scenarios lacking **commercial substance** are ignored in assessing whether a contract transfers significant insurance risk.

d. IFRS 2 notes that an entity 'has a present obligation to settle [a share-based payment transaction] in cash if the choice of settlement in equity instruments has no **commercial substance** (eg because the entity is legally prohibited from issuing shares)'.

e. Paragraph 10 of IAS 8 states: 'In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is: (…) reliable, in that the financial statements (…) reflect the **economic substance** of transactions, other events and conditions, and not merely the legal form'.

f. Paragraph 25 of IAS 19 states: ‘Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the **economic substance** of the plan as derived from its principal terms and conditions.’

g. Paragraph IG2 of the Guidance on Implementing IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* notes: ‘The ability to exercise power does not exist when potential voting rights lack **economic substance** (eg the exercise price is set in a manner that precludes exercise or conversion in any feasible scenario).’

h. Paragraph 9 of SIC 27 *Evaluating the substance of transactions involving the legal form of a lease* states that a fee from an investor ‘shall be presented in the income statement based on its **economic substance and nature**’.

i. Paragraph BC169 of the Basis for Conclusions on Business combinations refers to negative goodwill that does not have the ‘**economic substance** of a bargain purchase’.

j. Paragraph 35 of the *Framework* states: ‘If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their **substance and economic reality** and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. (…)’ Paragraph 51 states: ‘In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying **substance and economic reality** and not merely its legal form. (…)’

k. Several IFRSs refer to the substance of transactions, or use the phrase ‘in substance’, without further qualification.

36. In line with these precedents, the staff recommends that an insurer should recognise all contractual rights and contractual obligations arising from its insurance contracts, except purported rights and obligations that lack commercial substance (ie have no discernible effect on the economics of the contract because they do not modify significantly the risk, amount or timing of the cash flows from the contract).

37. One example of a contractual term that has commercial substance is a guarantee of insurability (unless the insurer has unconstrained ability to set a premium that effectively negates the guarantee).

What are contractual terms?

38. The proposed criteria refer to contractual rights and contractual obligations. Contracts exist not in isolation, but in the context of a particular system of legislation and regulation. Some contractual rights and contractual obligations exist because the contract describes them explicitly. Other contractual rights and contractual obligations arise from the contract, but the contract does not need to mention them explicitly because the legislative or regulatory environment imports them into the contract. These are contractual rights and obligations just as much as those that the contract mentions explicitly.

39. Similarly, in some cases, an insurer may have constructive obligations that build on the explicit obligations stated in the contract. We will consider at a later date, in the light of developments in the proposed amendments to IAS 37, whether we need to consider giving specific guidance on constructive obligations in this context.

40. Contracts are sometimes constructed in the context of external constraints, such as tax, that give policyholders significant incentives to act in a particular way. For example, in some countries, there are significant tax advantages for life insurance contracts,[2] but those advantages are lost if the policyholder surrenders the contract in the early years of the contract. Such constraints may affect the behaviour of the policyholder even if the contract itself contains no other term that affects that behaviour. Accordingly, some such constraints might be sufficient to introduce commercial substance into the insurer's right to benefit from the existing contract, even if the contract itself imposes no other restraint and creates no other incentives. Sometimes, such external constraints may be so integral to the design of the contract that they are best viewed as one of the characteristics of the contract.

[2] and investment contracts with the legal form of a life insurance contract

Application in particular cases

41. The following paragraphs discuss how the proposed criteria might operate for selected types of insurance contract.

    a. Annual non-life insurance contracts. For these contracts, both insurer and policyholder generally have unconstrained discretion not to renew the contract when the annual term ends. Therefore, the contractual rights and contractual obligations do not give rise to cash flows beyond the renewal date of existing contracts. That is the case even if the insurer priced the contract in the justified expectation that many policyholders will renew. (In consequence, the insurer may recognise a loss on the first contract, for example if acquisition costs are significant or if the information gathered by the insurer over time enables it to set more accurate premiums for policyholders with different risk characteristics.)

    b. Automatic renewals of annual contracts. In some cases, annual contracts are set up so that they renew automatically, unless the insurer or the policyholder cancels the contract before a specified date. Unless the pricing for the renewal differs from the pricing for an otherwise equivalent contract with a new policyholder, the right to potential renewal lacks economic substance. The right to benefit from potential renewals derives from the customer relationship, not from the contract. (The policyholder will find it more convenient to let the contract renew, but that convenience factor should not, in the staff's view, be sufficient to create contractual rights that have economic substance.)

    c. Group contracts. For group contracts, it may be necessary to consider whether the insurer has a single contract with the sponsor (eg an employer), or whether it has separate contracts with each individual participant. In the latter case, the measurement would not consider those future cash flows that derive from contracts with future participant.

    d. Retrospective rating and experience adjustments. In some contracts, the amount of premium payable after a renewal date depends on the experience of the contract before the renewal date. In some cases, that dependency gives the policyholder some participation in the experience of the contract and that participation may give the policyholder an incentive that favours, or discourages, renewal.

e. Bonus / malus systems. Motor insurance premiums often include adjustments to reflect the number of years since the policyholder made a claim. These adjustments enable the insurer to set differentiated premiums that reflect the risk generated by different policyholders. In some cases, these adjustments may affect the probability of renewal because they give policyholders an incentive to stay with the same insurer. In other cases, other insurers in the same country use similar (though not necessarily identical) adjustments, with the result that accumulated adjustments are effectively portable to another insurer: in these cases, the existence of the adjustment does not give the policyholder an incentive to renew, and so does not affect the likelihood of renewal. Some insurers offer policyholders the right to buy additional cover to protect a no-claims bonus: depending on the circumstances, such rights might introduce commercial substance into the insurer's right to benefit from some renewals.

f. Universal life contracts. For example, consider an account with the following features. Premiums are added to an account in the name of the policyholder. Interest is added to the account, based on either a crediting rate set by the insurer or based on the performance of a pool of assets or an index. The interest reflects an explicit or implicit investment management fee. Deductions from the account compensate the insurer for insurance cover provided and expenses incurred. The policyholder has discretion, within limits, to vary levels of premium and of insurance coverage bought. The contract lapses if the account is exhausted, or if the policyholder cancels the contract. The contract specifies minimum crediting rates or investment returns and maximum charges for life insurance and expenses. For such contracts:

    i. the policyholder needs to pay a minimum level of premiums to keep the contract in force. The insurer's right to receive those minimum premiums has economic substance.

    ii. the policyholder benefits from the guarantee of minimum returns on all premiums up to the maximum level of premiums for which the guarantee applies. The insurer's right to receive those minimum premiums has economic substance.

iii. the policyholder benefits from the guarantees of minimum returns and maximum insurance and expense charges throughout the term of the contract. These guarantees are likely to have a discernible effect on the willingness of the policyholder to keep the contract in force. Therefore, there is likely to be commercial substance in the insurer's right to benefit from insurance and expense charges, and from implicit or explicit investment management fees.

iv. if the contract permits the policyholder to pay additional premiums that do not benefit from guarantees of minimum investment returns and minimum insurance and expense charges, the insurer's right to receive those additional premiums lacks commercial substance and derives from the customer relationship, not from the contracts.

g. Investment contracts. Some contracts have the legal form of life insurance, but are in substance investments with an insignificant amount of insurance risk included to enable the contract to qualify as life insurance for legal or tax purposes. In many cases, the insurer's principal benefit from such contracts is the right to collect an explicit or implicit investment management fee. To the extent that the contract imposes significant constraints on exit (eg a significant surrender charge), the insurer's contractual right to benefit from the investment management fees has commercial substance. To the extent that the contract imposes no significant constraints, the insurer's contractual right to benefit from the investment management fees lacks commercial substance. However, in some cases, tax constraints might be sufficient to introduce commercial substance. We may need to consider this point in more detail if the Board adopts the proposed criteria.

h. Deficit in a participating fund. In some cases, although the assets of a participating fund are less than present value of policyholders' rights to the guaranteed minimum benefits, the insurer will not bear that shortfall if participating policyholders continue to pay premiums. The existence of the shortfall has a discernible effect on the economics of the contract. We will consider the application of the proposed criteria in more detail at a later date.

i. Financial guarantees. The FASB is developing guidance on claim liabilities for financial guarantee contracts. One issue that arises for some multi-year financial guarantee contracts is to determine whether the insurer should treat them as multi-year contracts or a succession of annual contracts. The staff presumes that the multi-year nature of such contracts is likely to have commercial substance, but we may need to research this further.

Questions for the Board

42. Do you agree with the following conclusions in this paper:

a. An insurer's contractual right to benefit from an existing insurance contract would typically qualify for recognition as an asset (paragraph 23)

b. That right is best viewed as a right to benefit from an existing contract, not as part of a right to benefit from an existing customer relationship. (paragraph 28)

c. A right to benefit from a contract with one policyholder might reduce another obligation to the same policyholder. It does not reduce or eliminate a contractual obligation to another policyholder, but the staff should investigate whether some aggregation might be acceptable on cost-benefit grounds (paragraph 29).

d. An insurer should not recognise purported rights and obligations that lack commercial substance (ie have no discernible effect on the economics of the contract because they do not modify significantly the risk, amount or timing of the cash flows from the contract) (paragraph 36).

e. Contractual rights and contractual obligations include the effect of terms that the legislative or regulatory (and, perhaps, tax) environment imports into the contract. They might (subject to further investigation) also include constructive obligations that build on the explicit obligations stated in the contract (paragraphs 38-40).

f. **The staff should investigate whether an insurer should present or disclose its right to benefit from an existing contract separately from its other rights and obligations.**

AGENDA PAPER 10C

Contractual cash flows that depend on policyholder behaviour – possible implications for other contracts

1. The table below summarises how the analysis in agenda paper 10B might apply to an entity's right to benefit from contracts other than insurance contracts. The second column from the left identifies whether those contractual rights is likely to have commercial substance. In several cases, more information might be needed about the contractual terms to assess whether commercial substance is present.

2. The analysis in this paper is preliminary. Its purpose is to give Board members some insight into possible implications if the criteria proposed in agenda paper 10B are applied more broadly.

3. For some of the examples, Board members may wish to consider whether an entity derives a benefit from a contract that gives the counterparty the right to buy goods or service at a discount that still generates a profit for the seller. This may depend on whether the sales generated by that right displace sales at full price or are incremental.

4. The Joint Working Group on Financial Instruments (JWG) discussed some of these examples in its Draft Standard and Basis for Conclusions on *Financial Instruments and Similar Items* (2000). The table below includes, among other things, some relevant extracts from the JWG's conclusions.

Area	*Substance?*	*Comments*	*Existing treatment*
1. Investment manager’s right to charge:			
• investment management fee if existing investor does not withdraw existing investments • investment management fee if existing investor continues to invest under a long-term investment plan	If there are exit or entry charges	If there is an exit or entry charge, investors cannot replace the service at the same price elsewhere. In measuring the right, it would be necessary to consider the cost of meeting the service obligation, and the required return.	Fees charged for managing investments are recognised as revenue as the services are provided. The contractual right to benefit from providing investment management services is recognised as an asset if the incremental costs of securing the investment management contract can be identified separately and measured reliably and if their recovery is probable. The entity may assess recoverability on a portfolio basis. [IAS 18, appendix.14(b)(iii)]
• exit fee if existing investor withdraws investments	Yes	Manager will collect exit fee from those investors who withdraw.	No specific guidance, but would presumably be recognised on exit.

Area	*Substance?*	*Comments*	*Existing treatment*
2. Supplier's right to benefit from purchases encouraged by a:			
• customer loyalty programme	Yes	If the programme permits the supplier to discontinue the programme at any stage without compensation, the programme may lack commercial substance.	IFRIC is investigating aspects of this issue (mainly related to the performance obligation).
• fixed price supply contract (ie price is fixed or capped, but quantity is at the buyer's option, up to a ceiling).	Yes	Commercial substance comes from: • fixed price commitment • guarantee of availability	Recognise revenue when the entity delivers goods or supplies services (and other conditions are met).
• take or pay contract	Yes	Commercial substance comes from requirement to pay a minimum amount if the goods are not bought.	Similar to long-term supply contract

Area	*Substance?*	*Comments*	*Existing treatment*
3. Supplier's right to benefit from customer decision (could include inertia):			
• to keep goods (that are not faulty) without exercising an unconditional right of return	Yes	Presumably, most customers are expected to accept the goods.	If there is uncertainty about the possibility of return, recognise revenue when the buyer has formally accepted the shipment or the goods have been delivered and the time period for rejection has elapsed. [IAS 18 Appendix, para 2(b)] Generally, the supplier recognises revenue on delivery and recognises a liability for estimated returns.
• not to cancel a service contract or construction contract	Yes …	… if the supplier's ability to reprice the contract is constrained, or if the supplier would have to pay a penalty to terminate its obligations.	Criteria for percentage of completion method include a contract that establishes 'each party's enforceable rights'. [IAS 11.29(a) IAS 18.23(a)]

Area	*Substance?*	*Comments*	*Existing treatment*
• not to cancel a newspaper subscription	Yes …	… if the supplier's ability to reprice the contract is constrained, or if the supplier would have to pay a penalty to terminate its obligations. The convenience factor is not enough to create commercial substance.	Recognise revenue: • on a straight line basis if items are of similar value; and • in proportion to sales value if values vary. [IAS 18 Appendix, para 7]
• to complete a contractually agreed real estate sale	Yes …	… if either party would face a penalty for not completing.	Recognise revenue when legal title (or an equitable interest) passes to the buyer, but later if the seller has: • further substantial acts to complete • continuing involvement • insufficient evidence of the buyer's commitment to complete payment [IAS 18 Appendix, para 9]

Area	*Substance?*	*Comments*	*Existing treatment*
• to make the final payment for lay away sales (ie sales under which the goods are delivered only when the buyer makes the final payment in a series of instalments)	Yes …	… if either: • the customer faces a penalty for cancelling (eg forfeit of earlier instalments), or • the supplier would face a penalty for cancelling	Recognise revenue when the goods are delivered. However, if most such sales are consummated, revenue may be recognised when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the buyer. [IAS 18 Appendix, para 3]

Area	*Substance?*	*Comments*	*Existing treatment*
4. Insurance agent's right to receive commission if policyholder continues to pay premiums	Yes	If the insurer's right to benefit from the underlying insurance contract qualifies for recognition as an asset, it seems logical that the agent's right to benefit from the related agency contract also qualifies (unless the insurer or policyholder can terminate the contract with the agent without also terminating the insurance contract). The agent may also need to recognise contractual performance obligations (or consider them in measuring its contractual rights).	If the agent is not required to render further services, recognise revenue on the effective commencement or renewal dates of the related policies. If it is probable that the agent will be required to render further services during the life of the insurance contract, defer the commission, or part of it, and recognise it as revenue over that period. [IAS 18 Appendix, para 13] [The guidance quoted from IAS 18 deals mainly with the deferral of commission already received, whereas the proposed criteria relate mainly to the agent's right to benefit from the existing contract.]

Area	*Substance?*	*Comments*	*Existing treatment*
5. Financial assets and financial liabilities:			
• Lender's right to benefit if borrower exercises a pre-payment option in a way that is beneficial to the lender (similar rights also exist for mortgage servicers)	Yes	The JWG suggested that fair value would consider estimated market expectations of the probable timings and amounts to be received (taking into account the probable effects of defaults and repayment behaviour) [JWG 335]	The fair value of a financial instrument reflects, among other things, expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities. [IAS 39.AG82(g)]

Area	*Substance?*	*Comments*	*Existing treatment*
• Lender's right to benefit if a borrower draws down a loan commitment	Yes	The borrower would need to go through a loan approval process before it can obtain a loan from another source. At draw down, the fair value of the loan will equal the amount advanced (unless the interest rate differs from the current market rate for a loan with similar characteristics). Some loan commitments permit the lender to refuse draw down if there has been a material adverse change in the borrower's financial position.	Measure the loan commitment at fair value (as a derivative) if it can be settled net, or is held for trading. [IAS 39.2(h)] For other loan commitments, IAS 37 applies (and requires a provision if the commitment is onerous) Defer commitment fees and recognise them: • as an adjustment to the yield (if a loan is probable) • on a time proportion basis (if no specific loan is likely). [IAS 18 Appendix 14(a)(ii) and (b)(ii)]

Area	*Substance?*	*Comments*	*Existing treatment*
• credit card provider's right to benefit if cardholder does not repay interest-bearing amounts as early as possible	Yes	The JWG suggested that fair value should assume holders will exercise options to borrow only when the options are in the money (that is, when the rates and terms are favourable to the holders in relation to available market rates and terms on the measurement date). JWG 4.23-4.27 JWG 332-335	It seems likely that credit card balances are generally carried at face amount (less loan loss provisions, when applicable)

Area	*Substance?*	*Comments*	*Existing treatment*
• bank's right to benefit if a depositor does not withdraw a current account or call account at the earliest opportunity [Benefit is net of estimated servicing costs]	Yes (?)	• The bank's right to benefit from non-withdrawal may lack commercial substance if the bank has an unfettered right to cancel the deposit without penalty (but the bank's right to cancel may itself have limited substance). • The bank's right to benefit from a depositor's access to a current account has commercial substance if opening a new account is costly or time-consuming. (That access may relate to contractual money transmission services, rather than the existing balance.) • The JWG suggested that fair value should reflect the market's expectations of the timing and amounts of withdrawals of the existing balance. [JWG 337]	The fair value is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. [IAS 39.49]

Area	*Substance?*	*Comments*	*Existing treatment*
• Traveller's cheque issuer's right to benefit if the purchaser does not cash in the cheques immediately. [Benefit is net of estimated servicing costs]	Yes	Most people do not buy travellers cheques to cash them in immediately at the same place.	The fair value is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. [IAS 39.49]
6. Customer relationships associated with financial assets and financial liabilities (And right to benefit from possible future contracts and transactions generated by those relationships):	No	'The fair value of a financial instrument excludes values (even if included in a market exit price) that are not directly attributable to the rights and obligations that constitute the instrument.' [JWG 92-94, JWG 4.18-4.32]	Not recognised (outside a business combination or separate acquisition)

Area	*Substance?*	*Comments*	*Existing treatment*
• Credit card provider's right to benefit from additional purchases by card holder. Benefit would include merchant fees, interest on the resulting balance (and perhaps customer list)	No	The provider's right may have commercial substance if the provider cannot cancel the holder's right to use the card to make purchases. Otherwise, the provider's right arises from the customer relationship, not from the existing contract.	Under general requirements of IAS 18 for service contracts, transaction fees charged to the retailer are recognised when the purchases are made. [IAS 18.20]
• Bank's right to benefit from additional deposits from a depositor at favourable interest rates	No	Nothing in the contract itself adds substance to the bank's right to benefit from future deposits. The bank may be free to refuse deposits or terminate the deposit relationship without notice.	Not recognised (outside a business combination or separate acquisition)

Area	*Substance?*	*Comments*	*Existing treatment*
• bank's right to benefit if a depositor rolls over a time deposit at market rates	No	Convenience should probably not be sufficient, by itself, to create commercial substance for an existing contract.	Not recognised (outside a business combination or separate acquisition)
7. Employer's right to benefit from:			
• employee's departure before benefits vest (pensions or other post-employment benefits)	Yes	IAS 19 does not distinguish employee's right to leave from employer's right to terminate employment before vesting.	Use unbiased **best estimate** of future employee turnover (except termination benefits. However, curtailments (material reductions in the number of employees covered by a plan), are recognised when they occur.
• employee's departure before benefits vest (share-based payments)	Yes		Vesting conditions, other than market conditions, are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount (and not in estimating their fair value). [IFRS 2.19]

Area	*Substance?*	*Comments*	*Existing treatment*
• employee's early exercise of share options	Yes?		Consider the effects of early exercise, in estimating the fair value of the share option, either by modelling early exercise in a binomial or similar model, or using expected life rather than contracted life as an input into an option pricing model. [IFRS 2.B17 and BC153-169]
• employee's decision to remain in a job that provides a lump-sum benefit payable at departure	Yes	Because of the time value of money, the amount that would be payable immediately may exceed the present value of the benefit at the estimated leaving date (ie the present value of the benefit attributable to service already completed at the end of the reporting period)	Measure the obligation using the estimated leaving date [IAS 19.68 (example 1) and Basis 63-65]

Area	*Substance?*	*Comments*	*Existing treatment*
8. Obligor's right to benefit if the counterparty to an onerous contract exercises it in a way that is favourable to the obligor. (IAS 37 defines onerous contract.)	Yes?	May depend on circumstances	The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. [IAS 37.66-69] IAS 37 suggests an expected value approach, but does not explicitly address counterparty options that are not exercised when in the money, or are exercised out of the money.
9. Issuer's right to benefit if the holder of an equity instrument elects to receive an equity instrument, rather than cash	Yes?	This example relates mainly to classification (liability versus equity), rather than to recognition. It is included here to indicate a possible ramification of the proposed criteria.	'an option for the holder to put the instrument back to the entity for cash or another financial asset means that the instrument meets the definition of a financial liability. ' [IAS 32.BC7]

Area	*Substance?*	*Comments*	*Existing treatment*
10. Finance lessor's right to benefit from lessee's contractual right to:			
• extend the lease	Yes?	May depend on circumstances If renewal is reasonably certain, this may imply that the lessor's contractual right has commercial substance. For specialised assets, the contractual right to benefit from renewals may have commercial substance.	Classification and measurement of finance leases reflect a lessee's option to renew if renewal is reasonably certain [IAS 17.3, IAS 17.9(c)] If the leased assets are so specialised that only the lessee can use them without major modifications, a lease would normally be classified as a finance lease. [IAS 17.8(e)]
• pay for additional usage (eg extra car mileage)	Yes	The lessee could not buy the additional usage cost-effectively without the underlying lease.	Do not reflect contingent rent (lease payments based on a factor other than just the passage of time—e.g., percentage of sales, amount of usage, price indices, market rates of interest). [IAS 17.3]

Area	*Substance?*	*Comments*	*Existing treatment*
• pay additional amount to break the lease	Yes…	…unless the additional payment is insignificant (in which case the value of the right to benefit from break fees is also insignificant).	A lease is not a 'non-cancellable lease' if it is cancellable upon additional payment by the lessee such that, at inception, continuation is **reasonably certain**. [IAS 17.3]
11. Lessor's right to benefit if the lessee does not exercise a cancellation right triggered contractually by a contingency	Yes …	… if some other contractual feature would influence the lessee's decision.	If a lease is cancellable only upon occurrence of some **remote contingency**, it is still a 'non-cancellable lease'. [IAS 17.3]