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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at Insurance Working Group meetings, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
Note: These notes are based on the staff paper prepared for the Insurance Working Group Meeting. Paragraph numbers correspond to paragraph numbers used in the Insurance Working group paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting: **Insurance Working Group, April 2008**
Paper: **Boundaries of a Contract (Agenda paper 9)**

Purpose of this paper

1. This paper deals with the question of how to determine the boundaries of a contract.
   If cash flows fall within the boundaries of existing contracts, they come into the measurement of existing insurance liabilities. Conversely, if cash flows fall beyond those boundaries, they relate to future contracts and do not come into the measurement.

Criteria in the Discussion Paper

2. In effect, the discussion paper proposed two separate tests for determining where the boundaries of existing contracts are located:

   (a) For a contract that is, or has become, onerous, the net obligation arising under the contract is recognised.

   (b) For a contract that is not onerous, the amount recognised represents (i) the net obligations assuming no future premiums, less (ii) the net benefit arising from (iiA) those premiums that pass a guaranteed insurability test less (iiB) additional cash outflows that result from those additional premiums.

3. Generally, respondents did not support the combination of the onerous contract test and the guaranteed insurability test. Instead, many respondents argued that the objective should be to measure existing contracts, without considering cash flows from possible future contracts. Respondents did not generally suggest how to distinguish existing contracts from possible future contracts, though some acknowledged that this distinction may be difficult to make and could need further work.

4. At this meeting, we do not plan to discuss whether the combination of the onerous contract test and the guaranteed insurability test is appropriate. The comment letters have already given us much input on that topic. Instead, we would like to focus for now on how to distinguish existing contracts from new contracts. In many cases, that may be clear, but in others it may be more difficult.

5. The discussion paper suggests that cash flows should be included if they result from substantive features of the contract. Cash flows that doe not arise from such features are not included, no matter how probable they are. The appendix to this paper contains extracts from the discussion paper dealing with this subject.

6. A few respondents suggested criteria that might help in locating the boundaries of an existing contract:

   (a) Some referred to the end of a contract as the earlier of the contractual expiry date and the future date at which the insurer has an unconstrained right to adjust all the terms of the contract

   (b) Some narrowed this criterion to an unconstrained right to re-price the contract or to reset the benefits.

   (c) Other respondents defined which conditions do not lead to the end of a contract, for example

      (i) a substantive renewal option or a predetermined/constrained renewal option together with the existence of surrender penalties

      (ii) a coverage period of more than one year in addition to a limitation on the right to increase future premiums or to cancel the contract.

Examples of possible problem areas

7. The following are examples of contracts where it may not be obvious where existing contracts end and new contracts begin:

   (a) Group health plans. Does the insurer have a single contract with the employer or separate contracts with each employee?

   (b) Bonus-malus systems in car insurance. Policyholders pay lower premiums if they have had no accidents in prior years. Are the resulting discounts inducements to renew with the same insurer, or a means of providing more accurate risk classification in future periods?

   (c) Health insurance contracts. In some jurisdictions, these contracts are multi-year contracts, but have been treated for accounting as annual contracts. In part, this may be due to government restrictions on repricing and on selection of policyholders.

   (d) Universal life contracts. If a contract permits additional voluntary premiums, are they part of that contract or a separate transaction?

Question for participants

8. **How would you distinguish existing contracts from new contracts?**

Appendix

Extracts from the discussion paper

152 In the view of some, the correct approach is to include all the cash flows that result from the contract, taking into account estimates of policyholder behaviour. However, in the Board's preliminary view, that approach would need to specify that cash flows are included only if they result from substantive features of the contract. Mere words on a piece of paper cannot be enough. For example, consider a one-year household insurance contract. 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 next year to renew the contract. Suppose the insurer changes the standard form of its contracts so that they become lifetime contracts, from which both the policyholder and the insurer are free to withdraw on any anniversary of the original contract date. Because this apparent contractual change creates no new substantive rights or obligations, it should not change the accounting.

153 It follows that some criterion is needed to ensure that policyholder behaviour is included only if it relates to contractual terms that create substantive rights or obligations. IFRSs refer in various places to notions such as substance, commercial substance, economic substance and economic reality. Therefore, the Board considered whether the criterion for including beneficial policyholder behaviour should be that it stems from contractual terms that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows from the contract). That criterion builds on generic notions that already exist in other IFRSs and does not treat insurance contracts as a special case.

154 Nevertheless, the Board concluded that introducing this notion could have significant consequences for other contracts, such as financial instruments, long-term supply contracts and leases. In addition, the Board noted that insurance contracts typically permit the policyholder to benefit from coverage for a period at a price that is contractually constrained. Accordingly, the Board's preliminary view is that future premiums (and resulting additional benefit payments to policyholders) should be

included in the recognised part of the customer relationship (and hence in the overall measurement of the insurance liability) if, and only if, any of the following criteria is met:

(a) the policyholder must pay the premiums to retain guaranteed insurability (a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained).

(b) the insurer can compel the policyholder to pay the premiums.

(c) including the premiums and the resulting policyholder benefits will increase the measurement of the liability.

….

157 The criterion of guaranteed insurability excludes some future cash flows, such as expected future premiums during the accumulation phase of an annuity if the contract does not transfer significant insurance risk during that phase.* Similarly, for universal life contracts,* the Board's preliminary view would include premiums, and the resulting additional policyholder benefits, if any of the criteria in paragraph 154 is met, and exclude all other premiums, such as those required to retain rights to other guarantees (eg guarantees of minimum crediting rates).

158 For many annual non-life insurance contracts, the policyholder has no guaranteed insurability beyond the end of the annual term. Thus, although the insurer may benefit from possible renewals, those renewals derive from a customer relationship that may lead to future contracts and would not affect the measurement of the insurance liability. Furthermore, that customer relationship does not qualify for recognition as an asset under IAS 38 (unless it was acquired separately or in a business combination).

* Footnote omitted