30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2008, London**
Project:	**Insurance Contracts**
Subject:	**Accounting for the whole contract? Some preliminary thoughts (Agenda paper 2B)**

Purpose of this paper

1. This paper considers whether there is a difference between the following two approaches:

   (a) Accounting separately for the rights and obligations created by a contract.

   (b) Accounting for a contract as a whole.

2. The purpose of this paper is to trigger some thinking and to identify a possible path for further research, without reaching conclusions at this stage.

3. The issues discussed in this paper might be relevant for several projects:

   (a) Insurance contracts

   (b) Revenue

   (c) Conceptual framework (definition of elements / recognition)

   (d) Leases

(e) Fair value measurements

(f) Financial instruments

(g) Non-financial liabilities (the project to amend IAS 37)

4. The rest of this paper deals with the following subjects:

   (a) What did the Discussion Paper propose and what did respondents say (paragraphs 6-7)?

   (b) General comments on the approach proposed by commentators (paragraphs 8-10)

   (c) Future premiums and other aspects of policyholder behaviour (paragraphs 11-15)

   (d) Participating contracts (paragraphs 16-20)

   (e) Does a contract create anything beyond the contractual rights and obligations? (paragraphs 21-24)

   (f) Unbundling - If separate rights and obligations are identified, should an insurer presented them as a single net amount or as one or more separate amounts? (paragraph 25)

   (g) Next steps on insurance contracts (paragraph 26)

5. This paper does not consider whether insurance contracts should be measured individually or as a portfolio.

What did the Discussion Paper propose and what did respondents say?

6. The discussion paper indicated that the project should deal with accounting for the rights and obligations that arise under those insurance contracts. In effect, this would result in a two stage approach:

   (a) Step one: look inside the contract to identify the individual rights and obligations.

   (b) Step two: recognise those individual rights and obligations that meet the criteria for recognition as assets and liabilities respectively.

7. In contrast, many respondents favour accounting for the contract as a whole, using a one-step approach:

   (a) If the contract meets the recognition criteria, recognise the whole contract as a single asset or liability.

General comments on the one-step approach proposed by commentators

8. Respondents asserted that the two-step approach is inconsistent with using current exit value as the measurement approach. These comments came both from respondents who favoured current exit value and from those who favoured other measurement objectives. Respondents argued that current exit value should consider all the cash flows that market participants would consider in pricing a transaction, without examining whether each individual cash flow relates to something that individually meets the definition of an asset or liability.

9. However, that argument is not necessarily valid in all cases. The starting point must be to define what we are measuring. Here are two examples:

   (a) Although transfers of insurance contracts are rare, when they do occur, it is quite likely that the transaction will involve not just the existing contract but also the right to benefit from future contracts with the policyholder (non-contractual renewals and cross-selling). Nevertheless, respondents generally agreed that the objective should be to measure existing contracts, without considering cash flows from possible future contracts. Therefore, if current exit value is adopted as the measurement attribute, it would have to be specified as the estimated price for a transaction that transfers the existing contract only without transferring the right to benefit from future contracts with the policyholder. Similarly, any other measurement attribute based on future cash flows would need to be applied only to those cash flows that are derived from existing contracts.

   (b) Under IAS 32 *Financial Instruments: Presentation*, a compound financial instrument (such as convertible debt) is split into a liability component (straight debt) and an equity component (conversion option). Generally, an entity would transfer the two components together. Nevertheless, if an entity wishes to determine the fair value of the liability component (for example to satisfy a disclosure requirement), it would consider the cash flows arising from that component only.

10. The one-step and two-step approaches will lead to different results if some individual rights and obligations under the contract do not qualify for recognition as assets or liabilities. In this regard, respondents highlighted two areas:

    (a) Future premiums and other aspects of policyholder behaviour (paragraphs 11-15)

    (b) Participating contracts (paragraphs 16-20)

Future premiums and other aspects of policyholder behaviour

11. For many life insurance contracts, policyholders pay regular premiums. Typically, the insurer cannot force the policyholder to continue paying premiums, though contracts often create economic incentives that encourage policyholders to continue paying. The discussion paper analysed such contracts as creating three distinct sets of cash flows:

    (a) Those cash flows that will occur if the policyholder pays no more premiums. For example, in a regular premium life insurance contract, the insurer must pay death benefits arising from deaths in the current month if the policyholder has already paid the premium for this month. Clearly, the measurement of the liability would reflect all these cash flows (with a small adjustment for estimated surrenders during the current month).

    (b) The additional net cash **out**flows that arise that will arise from future premiums under contracts that have become onerous. In example 7 in appendix G of the discussion paper, this would occur for policyholders who have become unhealthy. It is uncontroversial that the measurement of the insurance liability should include additional net cash outflows for the contracts that have become onerous.

    (c) Those additional net cash **in**flows that arise that will arise from those contracts that are not onerous. In example 7 of the discussion paper, this would occur for policyholders who are still healthy. The discussion paper:

        (i) treated these cash inflows as relating to (part of) a customer relationship, rather than as contractual cash flows.

(ii) proposed that the insurer would recognise that part of the customer relationship for cash flows that pass a guaranteed insurability test.

(iii) proposed, for practical reasons, that the insurer would combine those cash flows for recognition measurement and presentation purposes with the cash flows identified in (a) and (b)

12. The treatment of the cash flows in (a) and (b) is uncontroversial. However, many respondents opposed the treatment of the cash flows in (c). They argued as follows:

(a) Once a contract meets the recognition criteria, an insurer should recognise that contract as a single asset or liability, without dividing the contract into components for separate recognition.

(b) A measurement that excludes the cash flows in (c) would not be current exit value, because market participants would consider all the cash flows in (a), (b) and (c) in determining an acceptable price for a transfer of the insurer's rights and obligations under the contract.

Comments on the approach suggested by commentators

13. As noted in paragraph 9(a) above, the approach suggested by respondents would still need to distinguish existing contracts (including in the measurement) from possible future contracts (not included). In response to a specific question in the discussion paper, a few respondents mentioned that this distinction may be difficult to make and acknowledged that it would require further work. However, most respondents did not mention this point.

Comments on the discussion paper's approach

14. It is important to understand that the guaranteed insurability test as proposed in the discussion paper is not simply a test that distinguishes existing contracts from future contracts. Rather, the discussion paper proposed two separate tests:

(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 the guaranteed insurability test less (iiB) additional cash outflows that result from those additional premiums.

15. Arguably, the amounts recognised applying those tests do not correspond to the current exit value of any naturally definable group of contractual rights and contractual obligations.

Participating contracts

16. The discussion paper analysed participating insurance contracts as made up of two components:

(a) a non-participating component, such as a requirement to pay a fixed death benefit, and

(b) a participating component, such as a share in surplus generated by insurance experience or by investment returns.

17. The discussion paper proposed the following treatment:

(a) The non-participating component would be classified as a liability. This is uncontroversial.

(b) The participating component would be classified as a liability to the extent that it creates a legal or constructive obligation.

(c) To the extent that the participating component does not create such an obligation, that component would be classified in equity. It might be appropriate to require separate disclosure of this component, but the discussion paper did not explore the disclosure implications.

(d) Even if the participating component is classified in equity, the entire premium received would be included in profit or loss, although part of it relates to the equity component. This differs from the treatment of compound financial instruments in IAS 32. Under IAS 32, the part of the issue proceeds attributed to the equity component would appear in the statement of changes in equity, not in profit or loss.

18. Many respondents addressed concerns about the proposed treatment of participating insurance contracts (and, indeed, participating investment contracts.) They argued that:

(a) The contract should be measured as a whole, without distinguishing the participating and non-participating components.

(b) If the measurement of the insurance liability excludes the participating cash flows, that measurement would not be current exit value, because market participants would consider all the cash flows for both the participating and non-participating components in determining an acceptable price for a transfer of the insurer's rights and obligations under the contract.

(c) The premium paid for participating insurance contracts significantly exceeds the premium for an otherwise identical non-participating contract. If the measurement includes all the premiums but the participating component is classified in equity, a large gain will arise at inception and large losses will arise in later periods as participating benefits are distributed. Alternatively, if the margins are calibrated at inception to the actual premium, the participating component will be included implicitly in the margins, which would contradict the Board's aim of requiring margins to be explicit rather than implicit.

Comments on the approach suggested by commentators

19. In practice, if a participating contract were transferred, the whole contract would be transferred. Nevertheless, it does not necessarily follow that the entire contract should be classified as a liability. IAS 32 created a precedent for splitting one type of contract (a compound financial instrument) into separate liability and equity components. Moreover, there is no obstacle in principle to measuring the liability component separately. Thus, selecting current exit value as the measurement attribute for insurance liabilities would not automatically require that the whole contract should be classified as a liability. Instead, it is necessary to decide first what should be measured ((a) the whole contract or (b) only the parts of the contract that qualify for recognition as a liability). It is beyond the scope of this paper to consider that decision.

Interaction between policyholder behaviour and participation features

20. In practice, policyholder behaviour interacts with the insurer's distribution decisions: if an insurer pays lower dividends to policyholders, more policyholders are likely to cancel their contracts. These interactions may make it challenging to split contracts into components in more than one way at the same time (eg (a) including versus excluding future premiums as well as (b) including versus excluding participation). Arguably, this is an argument for accounting for the whole contract rather than for separate components.

Does a contract create anything beyond the contractual rights and obligations?

21. A contract could be viewed as an agreement between the parties that creates rights and corresponding obligations or other claims (ie equity interests).[1] There is no obvious reason to think that a contract creates anything else beyond those rights, obligations and other claims. Put differently, there is, arguably, no difference between:

    (a) a transfer of a contract, and

    (b) a transaction that transfers every right, obligation and other claim created by the contract, but transfers nothing else.

22. This implies that there is no substantive difference between the current exit value of the contract as a whole and the aggregate of the current exit values of each right, obligation and other claim created by the contract, except for any joint effects arising from interaction between the components.

23. Applying this line of thinking to the issues discussed in this paper:

    (a) Policyholder behaviour and future premiums: There should be no substantive difference (other than joint effects from interaction between the components) between the current exit value of the whole contract and the aggregate current exit values of (i) the net cash flows arising from past premiums and from contractually enforceable premiums [ie …..] plus (ii) the net cash flows arising expected premiums under existing contracts. We will need to consider separately how to define the boundary between existing contracts and future contracts; that is beyond the scope of this paper.

[1] In using the terms obligation and other claims, the staff is not trying to imply any particular approach to distinguishing liabilities from equity instruments

(b) Participating contracts:

(i) In principle, the current exit value of the contract equals the sum of the current exit values of the participating and non-participating features of the contract (other than joint effects from interaction between the features). Thus, adopting current exit value as the measurement attribute would not, by itself, automatically lead to classifying the whole contract as a liability. We will need to consider that issue separately, but that is beyond the scope of this paper.

(ii) One, possibly significant, joint effect between the components relates to the risk margin. Participating policyholders bear many of the risks that would otherwise fall on the insurer. Thus, from the insurer's perspective, the risk margin for the whole contract is likely to be lower than the risk margin for the non-participating component.

24. In many cases, when an insurer acquires a new policyholder, the insurer issues a contract to that policyholder and also originates a customer relationship with that policyholder. That customer relationship may lead to future profitable contracts. Nevertheless, although the contract and the customer relationship may, in some cases, both come into existence at the same time, the contract does not create the customer relationship. The contract creates only the contractual rights, obligations and other claims.[2]

Unbundling

25. The discussion paper proposed that insurance contracts should be unbundled (ie split into components) in some cases. Respondents generally opposed unbundling. They argued that unbundling would not result in useful information and would be costly. It is beyond the scope of this paper to consider these arguments in detail. Respondents also argued that unbundling would not arise if the objective were to account for the contract as a whole, rather than individual components of contract.

[2] Some of those rights, obligations and other claims may be stated explicitly in the contract itself. Others may be triggered by the contract, but stated explicitly in a law or regulation, rather than explicitly in the contract itself. There is no substantive difference between these two cases.

Next steps on insurance contracts

26. Over the next few weeks, we intend to consider the following questions:

(a) Can a contract qualify as a whole for recognition as an asset or liability, or should the recognition criteria be applied separately to the individual rights, obligations and other claims created by the contract? (seeking input from the conceptual framework team)

(b) In relation to policyholder behaviour and future premiums: (seeking input from the revenue recognition, financial instruments, leases and conceptual framework teams)

(i) Can a contract create anything other than rights, obligations and other claims (such as equity / ownership interests)?

(ii) Is it more appropriate to think of expected net benefits from future premiums as part of the contract or as part of a customer relationship?

(iii) The discussion paper proposed a combination of a guaranteed insurability test (for non-onerous contracts) with an onerous contract test. Is this an appropriate way to distinguish existing contracts from possible future contracts?

(iv) The guaranteed insurability test proposed in the discussed paper refers to future premiums. Could the same notion apply to other aspects of policyholder behaviour?

(v) How would the guaranteed insurability test apply for contracts with more flexible premium terms, such as universal life contracts?

(c) Should participating insurance (and investment) contracts be recognised and measured as a whole, or should the participating and non-participating elements be candidates for separate recognition and measurement? (seeking input from the liabilities and equity, non-financial liabilities [IAS 37] and conceptual framework teams)