Project **Insurance Contracts**

Topic **Recognition of an insurance contract**

## Purpose

1. This paper discusses the recognition of rights and obligations arising under insurance contracts, including the treatment of the contract in the period (if any) between entering into the contract and the start of the coverage period.

## Summary of Staff recommendations

2. This paper argues that an insurer should recognise insurance contracts when it becomes a party to the contract, applying the recognition principle in IAS 39 *Financial Instruments: Recognition and Measurement*.

3. The staff prepared this paper in the context of IFRSs. The staff expects that a similar analysis in the context of US GAAP would lead to the same recommendation.

## Structure of the paper

4. The rest of this paper is divided into the following sections:

   (a) Background (paragraphs 6-8)

   (b) Treatment of the contract before the start of the coverage period (paragraphs 9-23)

   (c) Other issues (paragraphs 24-25)

   (d) Conclusion (paragraphs 26-28)

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This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

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(e) Embedded options for future coverage (paragraphs 29-32)

5. It is beyond the purpose of this paper to discuss whether the investment component should be reported off balance sheet if it is regarded as funds under management, rather than as an asset and liability of the insurer. We will ask the boards to discuss that at a future meeting, particularly in the context of unit-linked contracts (known in the US as variable contracts).

## Background

6. The discussion paper (DP) *Preliminary Views on Insurance Contracts* proposed that an insurer should recognise insurance contracts when it becomes a party to the contract, applying the recognition principle currently included in IAS 39 and to be included in the forthcoming IFRS on Financial Instruments. Paragraph 14 of IAS 39 states: “An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)”. (As discussed in paragraph 16 of this paper, paragraph 38 of IAS 39 permits settlement date accounting in some circumstances.)

7. Respondents generally agreed with the approach to recognise insurance contracts when an insurer becomes a party to the contract. But some respondents noted that, in some cases, insurance contracts are entered into before the start of coverage period. Often the period between entering into a contract and the start of the coverage period is relatively short and the impact of the timing difference will probably be limited.

8. But in some cases the period between entering into a contract and the start of the coverage period can be significant (for example a few months). In this respect, respondents identified two other possible recognition principles:

   (a) recognise an insurance contract when coverage starts and treat it as fully executory until the start of the coverage period (paragraphs 9-11)

(b) recognise an insurance contract when coverage starts and treat it as a forward contract or option (derivative) until the start of the coverage period (paragraphs 12-16).

## Treatment of the contract before the start of the coverage period

### *Treat the insurance contract as executory*

9. Some viewed insurance contracts as service contracts, but felt that the discussion paper's approach to recognition was consistent with a view that insurance contracts are financial instruments. Those respondents preferred to treat insurance contracts as fully executory until the coverage period begins. Under that approach, until the coverage period begins, the insurer would treat any premium received as a deposit, with a liability adequacy test applied if the contract were onerous.

10. Staff believes that selecting the recognition approach should not necessarily depend on how one looks at an insurance contract (i.e. whether it is a financial instrument, a service contract or something else). More relevant is in our view the potential impact in terms of measurement. The outcome of an insurance contract can be highly variable because uncertainty is an inherent characteristic of insurance contracts. Those changes in circumstances might even occur between signing a contract and the start of the coverage period, for example:

    (a) changes in discount rates, particularly when duration of the cash inflows (premiums) and cash outflows (benefits and expenses) differs significantly.

    (b) updates of longevity for, for example, long-term annuity business.

    (c) embedded derivatives.

11. If a contract were not recognised until the start of the coverage period, the financial statements of the insurer would not report changes in circumstances unless the contract becomes onerous.

***Treat the insurance contract as a derivative***

12. If the insurance contract provides coverage starting at a future date (i.e. a date later than the date the contract was signed), that contract gives rise to:

    (a) the insurance coverage specified in that contract starting at a future date (i.e. the start of the coverage period), and

    (b) until the coverage period starts, a free-standing (i.e. not part of a combined insurance contract) derivative for future insurance coverage.

13. A free-standing derivative for future insurance coverage itself meets the definition of an insurance contract in IFRS 4 *Insurance Contracts* and is within the scope of IFRS 4. Staff will bring the issue of definition and scope in a future meeting, but we do not intend to recommend any changes for those derivatives. If the boards accept that conclusion, derivatives meeting the definition of an insurance contract would remain in the scope of the future insurance standard, with as a consequence there would be no difference in measurement outcome between:

    (a) recognising and measuring the contract as an insurance contract as from the date the insurer became a party to the contract; and

    (b) a two-step process that:

        (i) first recognises and measures the contract as a derivative that meets the definition of an insurance contract as from the date the insurer became a party to the contract up to the start of the coverage period; and

        (ii) from the start of the coverage period recognises and measures it as an insurance contract.

14. The approach under 12(a) results in a single recognition trigger at the inception of the contract and a single measurement approach throughout its life cycle. The approach under 12(b) uses two recognition triggers, one for the derivative and one for the resulting contract, but for both sections of the overall life cycle, the same measurement model would apply. For measurement, it therefore does not matter whether one:

    (a) measures the entire contract, including the derivative, under the future insurance model; or

(b) measures first the derivative and subsequently the resulting insurance contract under the future insurance model.

15. However, we believe that a two-step approach (as in (b) above) leads to unnecessary complexity. In addition, we believe that a two-step approach is inconsistent with the terms of the contract. There is not a separate derivative contract at inception, settled later by delivery of a non-derivative. The contract is a single contract throughout its life cycle.

16. Some noted that IAS 39 allows settlement date accounting in some cases. If 'settlement date accounting' in accordance with IAS 39 were to be applied to an insurance contract, the insurer would account for changes in the value between the 'trade date' and the 'settlement date' in the same way as the insurance contract it entered into. In other words, 'settlement date accounting' would have the same measurement impact on profit or loss as if the contract were to be recognised at the date it was signed. We therefore do not see a particular merit in applying 'settlement date accounting'. It would add complexity, for no benefit in terms of improved information for users.

***Forward versus option***

17. In the previous section staff argued for a single recognition trigger throughout the life cycle of a free-standing derivative for future coverage and then the resulting contract. A free-standing derivative for future insurance coverage can be either

(a) a **forward** if both the insurer and the policyholder cannot cancel or decline the future coverage or change the terms and conditions of that coverage (see paragraph 18), or

(b) an **option** if the policyholder has the possibility to cancel the future coverage between signing the contract and the start of the coverage period but the insurer cannot decline coverage or change the terms and conditions during that period (see paragraphs 19-23).

*Forward for future coverage*

18. The approach of a single recognition trigger can be applied to a forward contract because neither party can get out of the contract before the coverage period starts.

*Option for future coverage*

19. In some cases, the policyholder has the option to cancel the insurance coverage before the coverage period starts. This option is in our view very similar to an option that allows the policyholder to cancel the contract during the coverage period. In both cases, cancellation means that the policyholder loses coverage for the remainder of the original coverage period.

20. To deal with such options, the IASB decided tentatively that the measurement of an insurance contract includes future cash flows that depend on policyholder behaviour on an expected value basis if, and to the extent that, they are part of an existing contract. [1] (The FASB has not yet reached a tentative conclusion on this issue.) Staff will develop a definition for which cash flows arise from an existing insurance contract based on the insurer's ability to cancel, or change the pricing or other terms, of the contract.

21. A free-standing option for future insurance coverage meets the definition of an insurance contract itself (see paragraph 13). If such an option remains within the scope of the future insurance standard, it would be measured under the future insurance model, including the treatment of cash flows from policyholder behaviour on an expected value basis. Staff therefore concludes that the measurement of a free-standing option for future insurance coverage can be dealt with by:

    (a) using the single recognition trigger at the beginning of the whole life cycle of the contract (i.e. the option and then the resulting coverage period).

[1] IASB May 2009, agenda paper 16A.

(b) including the cash flows that depend on policyholders exercising their options in accordance with the proposed treatment of policyholder behaviour.

22. Typically, the free-standing option will not give the insurer the ability to decline future coverage or change the pricing or other terms of that coverage. In that case, all other things being equal, the outcome of the measurement will be the same for a forward contract and an option contract.

23. In addition we note the following:

    (a) If both the insurer and the policyholder have the right to decline future coverage or change terms and conditions of the future coverage, there will be no basis for recognising the derivative or the resulting contract before at least one of the parties is committed (e.g. when the coverage actually starts). Such a contract would, in the staff's view, not meet the IASB's current definition of an insurance contract at issuance because at that stage the contract transfers no risk to the insurer.

    (b) We did not analyse in detail a situation where the insurer has the option cancel or amend future coverage, but the policyholder has no such option. Staff is not aware of such cases.

## Other issues

24. The IASB decided tentatively to require an unearned premium approach for pre-claims liabilities of short-duration insurance contracts. [The FASB will discuss this topic at a future meeting.] In our view, it would be quite straight-forward to apply an unearned premium approach from the date when the insurer becomes a party to the insurance contract. If the insurer receives no premium before the start of coverage, the measurement will be nil until coverage starts (unless the contract is onerous). If the insurer has received some or all of the premiums before the beginning of coverage, all those premiums are treated as unearned until coverage starts.

25. Many respondents felt that recognising the contracts when the insurer becomes a party to the contract would lead to practical issues of data collection and that the associated cost would exceed any benefits. However, staff believes those issues

may not be very different from the challenges an insurer might have with data collection at the start of the coverage period.

## Conclusion

26. In the staff's view, the proposal in the DP to recognise an insurance contract at the date the insurer becomes a party to the contract is appropriate; any other approach would either:

    (a) ignore some changes in circumstances between the date the insurer entered into the contract and the start of the coverage period, or

    (b) create unnecessary complexity.

27. Staff therefore recommends that an insurer should recognise insurance contracts when it becomes a party to the contract, applying the recognition principle in IAS 39.

28. As mentioned earlier, in many cases the coverage period starts soon after the insurer became a party to the contract. In those cases, there will be little difference in practice between recognising the contract when the insurer becomes a party to the contract and recognising it at the start of the coverage period.

| **Question 1 for the boards** |
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| Staff recommends in paragraph 27 that an insurer should recognise insurance contracts when it becomes a party to the contract, applying the recognition principle in IAS 39.<br><br>Do you agree with the staff recommendation? |

## Embedded options for future coverage

29. Some Board members asked in a previous meeting whether the measurement of insurance contract would include the expected present value of cash flows arising from an embedded policyholder option to buy additional coverage (or other goods or services) unrelated to the primary risk covered by the insurance contract. Board members cited examples of options that:

(a) give the policyholder the right to buy insurance coverage other than the coverage specified by the current contract (e.g. different type of coverage, different periods);

(b) provide other (potential) policyholders (e.g. the policyholder's spouse) with the opportunity to buy insurance coverage at specified terms or conditions (e.g. with a discount).

(c) give the policyholder the right to buy other goods or services at specified terms or conditions (e.g. with a discount).

30. We examine that question by considering first how the insurer would account for a free-standing option for the policyholder to buy additional insurance coverage at a price or conditions that are constrained (such as the options described in paragraph 29(a) and (b)). As discussed, in the previous section, the insurer would recognise a free-standing option when it enters into the option and measure the contract throughout its life (both before and after exercise of the option) using the future model for insurance contracts. Consider now a similar option embedded in a (larger) host insurance contract. If, the insurer includes the measurement of the embedded option in the measurement of the whole contract, the result would be the same as if that option is excluded and treated as a free-standing option: in both cases insurer would recognise the option when it enters into the insurance contract and measure that contract throughout its life using the future model for insurance contracts.

31. We next consider what would happen if the policyholder option is to buy the additional coverage at a price or conditions that are **not** constrained (for example, at the price the insurer would set if it issued a new contract when the policyholder exercises the option.) That option would not fall within the boundaries of an existing contract and would therefore not be included in the measurement of the liability. Similarly, if the option were free-standing, it would not, in the staff's view, meet the IASB's current definition of an insurance contract at issuance because at that stage the contract transfers no risk to the insurer. Thus, the option would not qualify for recognition at that point. Again, the outcome would be the same for both the embedded option and the free-standing option.

32. Finally, we consider an embedded option for the policyholder to buy other goods or services (paragraph 29(c)). Although the boards have not completed their discussion of unbundling, in the staff's view it is clear that that option would not be treated as part of the insurance contract and would be within the scope of the boards' respective standards on revenue recognition. [We will consider this issue when developing the contract boundaries.]

| Question 2 for the boards |
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| Do you have any comments on paragraphs 29-32? |