STAFF PAPER

12 -16 December 2011

**REG IASB | FASB Meeting**

| **Project** | **Insurance contracts** | | |
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| Paper topic | Onerous contracts | | |
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## What is the paper about?

1. The purpose of this paper is to discuss the definition, identification and measurement of onerous contracts:
   (a) for all insurance contracts during the pre-coverage period; and
   (b) for the liability for remaining coverage for contracts accounted for under the premium allocation approach.
2. This paper will not discuss whether an onerous contract test is needed under the single margin approach. This will be discussed at a future meeting.
3. This paper does not address instances in which the adverse event (e.g. in the case of a catastrophe, a hurricane) extends beyond a reporting period. This issue will be addressed in a future paper.
4. Agenda paper 7B/77B discusses the unit of account that should be used when applying the onerous contract test.

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## Summary of Staff recommendation

5. The staff recommend the following:

   (a) An insurance contract is onerous if, the expected present value of the future cash outflows [plus the risk adjustment for the IASB] exceeds:

      (i) the expected present value of the future cash inflows (for the pre-coverage period).

      (ii) the carrying amount of the liability for remaining coverage (for the premium allocation approach).

   (b) To confirm that insurers should perform an onerous contract test when facts and circumstances indicate that the contract might be onerous.

   (c) The measurement of an identified onerous contracts liability should be updated at each reporting period.

   (d) Onerous contracts identified in the pre-coverage period should be measured on a basis consistent with the measurement of the liability recognised at the start of the coverage period. Similarly, onerous contracts identified under the premium allocation approach should be measured on a basis consistent with the measurement of the liability for incurred claims.

   (e) [IASB only] The risk adjustment should be considered when identifying onerous contracts, and the measurement of an onerous contract liability should include a risk adjustment.

## Background

6. An onerous contract is usually understood to mean a contract in which the future costs of fulfilling the contract are expected to exceed the future benefits expected to arise from that contract.
7. Insurers are required to perform an onerous contract test in many jurisdictions. The purpose of an onerous contract test is to determine the amount by which the

expected cash flows (ie claims, claim adjustment expenses, policyholder dividends, maintenance costs, unamortized acquisition costs, including unpaid commissions) exceed the related unearned premium (including any future installment premiums). In some jurisdictions the test is performed using the undiscounted expected cash flows, and some of those jurisdictions consider some or all anticipated investment income as a factor in the test.

8. Under the building block approach, an insurer recognises a liability that is equal to the present value of the fulfilment cash flows plus a residual margin (single margin for the FASB). The present value of the fulfilment cash flows is the difference between the expected present value of cash inflows and the expected present value of cash outflows (with a risk adjustment for the IASB) under the contract. Because the building block approach recognises a liability when expected future cash outflows exceed expected future cash inflows, a separate onerous contract test is unnecessary in that approach.
9. However, in the following situations the insurance liability is not measured using the building block approach:
   - (a) *the pre-coverage period*—the boards have tentatively decided that insurance contract assets and liabilities should initially be recognised when the coverage period begins. This decision means that no liability is recognised between the date the insurer becomes a party to the contract and the start of the coverage period (the pre-coverage period). Consequently, the boards have also tentatively decided to require the recognition of an onerous contract liability in the pre-coverage period if management becomes aware of onerous contracts in that period.
   - (b) *the liability for remaining coverage* under the premium allocation approach – which is not remeasured but allocated to profit or loss over the coverage period. As a result the carrying amount of the liability for remaining coverage may be less than the expected present value of future cash outflows. Consequently, the boards tentatively decided that an

insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.

10. For these special circumstances this paper will discuss the definition, identification and measurement of onerous contracts.
11. The exposure draft included a requirement to test for onerous contracts under the premium allocation approach[1]. The table below compares the exposure draft *Insurance Contracts* (ED) proposals with recent discussions.

| | *ED* | *Further considerations* |
|---|---|---|
| What is an onerous contract? | 12. 'An insurance contract is onerous if, at initial recognition or subsequently, the present value of the fulfillment cash flows relating to future insured claims that are within the boundary of an existing contract exceeds the carrying amount of the pre-claims obligation.' | It is discussed in paragraphs 16-17. |
| Identifying onerous contracts | 'If a contract is onerous …' | At their meeting on 27 April 2011, the boards tentatively decided that an insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre- |

[1] The ED proposed that insurance contract assets or liabilities should be recognised when the insurer becomes a party to the insurance contract. Consequently, an onerous contract test in the pre-coverage period was not required.

| | *ED* | *Further considerations* |
|---|---|---|
| | | claims period.<br><br>At their meeting on 24 October 2011, Insurance Working Group members supported this decision.<br><br>It is discussed further in paragraphs 18 - 22. |
| Measurement | 'If a contract is onerous, the insurer shall recognise an additional liability and a corresponding expense, measured as the difference between the carrying amount of the pre-claims obligation and the present value of the fulfillment cash flows. ' | Agenda paper 8A for the week commencing 18 July 2011 discussed that including a risk adjustment might not be necessary for both initial and subsequent measurement of an onerous contract.<br><br>At their meeting on 24 October 2011, some Insurance Working Group members supported excluding the risk adjustment.<br><br>It is discussed further in paragraphs 25 - 41. |
| Subsequent remeasurement | 'An insurer shall update the measurement of that additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous.' | It is discussed in paragraphs 23 - 24. |

*Onerous contracts in the Revenue project*

13. The boards have discussed onerous contracts in the Revenue project. In their re-exposure draft *Revenue from Contracts with Customers*, published in November 2011, the boards propose that, as a practical expedient, an entity would apply the onerous contract test only to performance obligations that an entity expects at contract inception will be satisfied over a period of time that is greater than one year. If a similar decision were taken in the Insurance Contracts project an onerous contract liability would not be recognised for insurance contracts of with a coverage period of less than one year. This would probably include many of the contracts accounted for under the premium allocation approach.
14. The boards mentioned the following arguments in favour of limiting the scope of the onerous contract test in the Revenue project:

    (a) It limits the risk that the onerous contract test may have unintended consequences for some contracts, because such a scope limitation is consistent with current revenue recognition practice in some jurisdictions.

    (b) It would address some cost-benefit concerns because it would reduce the number of situations in which an onerous contract test would be required.

    (c) It is unlikely that unfavorable changes in assumptions will have a significant impact on any liability in the relatively short time period of one year.

15. The staff acknowledges that the practical expedient introduced for the Revenue project would reduce the number of contracts that need to be tested. However, the staff believe that this approach is not appropriate in the Insurance Contracts project because:

    (a) Insurance contracts are subject to more uncertainty than most revenue contracts. This means that onerous contracts may arise more often and be more significant;

    (b) The unintended consequences which the boards wanted to avoid in the Revenue project were mainly related to the unit of account (for example,

the first tickets sold on an airplane could be priced at a loss despite the flight overall being profitable). That reason is not relevant to the insurance contracts standard which generally considers a portfolio unit of account. Unit of account issues related to insurance contracts are dealt with in agenda papers 7B/77B;

(c) The staff believes that the boards have addressed the cost-benefit issue by requiring entities to perform the onerous contract test only when facts and circumstances indicate that the contract has become onerous (this will be discussed further in paragraphs 18 - 24).

(d) Performance obligations excluded from the scope of the onerous test in the Revenue project typically have or result in the creation of related assets that would be subject to impairment testing in other standards. This is not the case with insurance liabilities.

(e) An onerous contract test was proposed in the ED, and no significant issues were raised. The staff believes this is possibly because most jurisdictions require some form of such a test today.

### What is an onerous contract?

16. Paragraph 60 of the ED states that under the premium allocation approach:

> An insurance contract is onerous if, at initial recognition or subsequently, the present value of the fulfillment cash flows relating to future insured claims that are within the boundary of an existing contract exceeds the carrying amount of the pre-claims obligation.

17. The staff notes that:

(a) The fulfillment cash flows include a risk adjustment (IASB only). Whether a risk adjustment should be included when testing for or measuring onerous contracts is discussed further in paragraphs 28 - 41.

(b) There is no liability for remaining coverage recognised during the pre-coverage period. This means that paragraph 60 of the ED needs to be modified to apply to the pre-coverage period.

(c) Applying the same concept for both the pre-coverage period and the premium allocation approach would be simpler to apply.

### *Questions to the Board*

| **Question 1: Definition of onerous contract** |
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| Do you agree that an insurance contract is onerous if the expected present value of the future cash outflows [plus the risk adjustment for the IASB] exceeds:<br><br>(a) the expected present value of the future cash inflows (for the pre-coverage period)?<br><br>(b) the carrying amount of the liability for remaining coverage (for the premium allocation approach)? |

## Identification and subsequent re-measurement of onerous contracts

18. In previous discussions the boards tentatively decided:

    (a) an onerous contract liability should be recognised if management becomes aware of onerous contracts in the pre-coverage period;

    (b) under the premium allocation approach an insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.

19. The staff believes that the boards’ intentions were similar in both tentative decisions. During their discussions the boards concluded that, because the pre-coverage period and the coverage period for the premium allocation approach are generally short, it is unlikely that unfavorable changes in assumptions will have a significant impact on the measurement of the liability. Consequently, it would be

unnecessary to require ongoing assessment of whether a contract is onerous. However, occasionally a change in facts or circumstances may result in a significant impact on the obligations under the contract. Therefore, the insurer should test for onerous contracts if facts or circumstances indicate that a contract has become onerous.

20. The most general guidance on testing for onerous contracts is in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets /* ASC 450-20 *Loss Contingencies,* and the Revenue project. This guidance states that a liability should be recognised if the contract is onerous. The staff believe that requirements similar to those in IAS 37 and ASC 450-20 may place a significant burden on insurers because they would be expected to perform onerous contract testing on an on-going basis. As discussed above, in the Revenue project the boards decided to limit the requirement to perform onerous contract tests to those contracts which are expected to be satisfied over more than one year. However, as explained in paragraphs 13-15 the staff believes the same practical expedient should not be used for insurance contracts.
21. Instead, the staff believes that the boards should confirm their previous decisions (see Appendix A) that an insurer should be required to test for onerous contracts (both in the pre-coverage period and under the premium allocation approach) when facts and circumstances indicate that the contract might be onerous.
22. The staff notes also that, at their meeting on 24 October 2011, the Insurance Working Group members supported the proposal to test for onerous contracts under the premium allocation approach only when facts and circumstances indicate that the contracts might be onerous.

*Subsequent measurement*

23. Paragraph 60 of the IASB's ED states "*an insurer shall update the measurement of the additional liability at the end of each reporting period….*" This is consistent with the treatment of liabilities recognised under the building block approach and with the treatment of onerous contracts in IAS 37 and the proposals in the Revenue project.

24. Consequently, the staff recommends that the board should confirm the ED proposals that the measurement of onerous contract liabilities should be updated at each reporting period, after the insurer has identified those contracts as onerous.

### *Questions to the Board*

| **Question 2: Identification of onerous contracts** |
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| Do you agree that, for the premium allocation approach and during the pre-coverage period:<br><br>(a) insurers should perform an onerous contract test when facts and circumstances indicate that the contract might be onerous?<br><br>(b) the measurement of the liability for identified onerous contracts should be updated at each reporting period? |

### *Measurement of the liability for onerous contracts*

25. Unless the liability for onerous contracts is measured on a basis that is consistent with the measurement of the liability recognised at the start of the coverage period or the liability for the incurred claims, gains (for example if discounting is not applied) or losses (for example if a risk adjustment is not included (IASB only)) could subsequently arise when:

    (a) the coverage period starts (for onerous contracts previously identified in the pre-coverage period); and

    (b) a claim liability is recognised (for onerous contracts previously identified under the premium allocation approach).

26. The staff notes that in some jurisdictions, under the current requirements, anticipated investment income is included in the measurement of the liability for onerous contract and this liability is not discounted. However, not discounting the liability and including anticipated investment income would be inconsistent with the

building block approach and would result in the gains and losses described in paragraph 25.

27. To avoid these gains or losses the staff believes that onerous contracts identified either in the pre-coverage period or under the premium allocation approach should be measured using the basis that is consistent with the measurement of the liability recognised at the start of the coverage period or the liability for the incurred claims. In addition, the onerous contract test should be performed without consideration of anticipated investment income, but including the effect of discounting.

### *Risk adjustment (IASB only)*

28. The IASB has tentatively decided to define the risk adjustment as the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract.
29. The following sections discuss whether the risk adjustment should be considered when identifying or measuring onerous contracts.

#### *Relevant comments received*

30. Some respondents to the ED indicated that including a risk adjustment in the onerous contract test could result in recording losses for contracts that are ultimately profitable. These respondents view the risk adjustment as deferred profit that will be earned if the actual expected cash flows do not exceed those determined at contract inception. These respondents believe that determining a contract is in a loss position based on the expected cash flow plus what some consider to be a portion of expected profit that is at risk (risk adjustment or a single margin) would be unduly burdensome.
31. However, the staff notes that the risk adjustment as characterised by the IASB is not considered to be deferred profit. It is part of the building block measurement of the insurance liability. Therefore, the staff believes that this view misrepresents the objective of the risk adjustment.
32. Many respondents suggested that the liability for remaining coverage should be more like the ‘Unearned Premium Reserve’ (UPR) which is used widely in practice.

Some respondents therefore did not believe it was appropriate to include a risk adjustment as part of the liability for onerous contracts under the premium allocation approach. Additionally, some respondents suggested that requiring the insurer to apply the full building block approach routinely to determine whether contracts were onerous would over-complicate the premium allocation approach.

33. At their meeting on 24 October 2011, some Insurance Working Group members supported excluding the risk adjustment from the measurement of onerous contract liability under the premium allocation approach.

*Staff analysis*

34. The staff notes that in the Revenue project, the boards propose to exclude a risk adjustment when measuring the liability for onerous contracts.
35. Agenda paper 8A for the board meeting during the week commencing the 18 July 2011 (FASB memo 71A) discussed whether to exclude a risk adjustment from the measurement of the liability for the onerous contracts under the premium allocation approach. The staff provided the following arguments in favour of excluding the risk adjustment from the onerous contract liability:

    (a) contracts would be identified as onerous less frequently. The onerous contract test would become an exception rather than a rule.

    (b) the onerous contract test, when required, would be simpler to perform, consistent with the aims of the premium allocation approach.

    (c) although the liability would be different from the liability as measured under the full building block approach, the differences might not be substantial. For contracts accounted for under the premium allocation approach, the period of unexpired coverage is generally short, and the liability for unexpired coverage is very quickly replaced with a liability for incurred claims. Similarly, in most situations the pre-coverage period is short and the liability is quickly replaced by another liability.

    (d) being consistent with revenue recognition removes differences between the accounting treatments for insurance contracts and for contracts within

the scope of revenue recognition—which may reduce the pressure on the scope of the project.

(e) a loss may be recognized on a potentially profitable contract simply because of the inclusion of a risk adjustment.

36. However, the staff note that:

(a) An explicit risk adjustment is already a part of the measurement for insurance contracts (unlike the Revenue project) and not including a risk adjustment would make the measurement inconsistent with liabilities measured under the building blocks approach leading to possible gains or losses when an onerous contract liability is replaced by a liability measured under the building blocks approach;

(b) Not requiring a risk adjustment might create a further difference between the building block approach and the premium allocation approach,

(c) it might not be simpler to exclude a risk adjustment in the premium allocation approach, given that a risk adjustment might be required to be measured when claims are incurred;

(d) The Revenue project covers a wide spectrum of diversified activities and companies for whom calculation of a risk adjustment would be unnecessarily complex. Insurers, however, are in the business of managing risk and have more experience of calculating risk adjustments;

(e) Insurance activity is inherently more uncertain and a risk adjustment is seen by some as a significant explicit measurement component of the liability (as decided by the IASB on 17-20 May 2011);

(f) Including a risk adjustment is consistent with the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 36 *Impairment of assets;*

37. Staff believes that these arguments are applicable to the liability for onerous contracts in the pre-coverage period as well as for contracts measured under the

premium allocation approach. For the reasons set out in paragraph 36, the staff recommends that the measurement of onerous contract liabilities should include a risk adjustment.

38. Some staff believe the risk adjustment could be excluded when *identifying* onerous contracts. For example, the boards could decide that a contract would only be treated as onerous if the expected present value of the future cash outflows (excluding a risk adjustment) is exceed the expected present value of the future cash inflows. However, contracts that are *identified* as onerous would be *measured* using the full building blocks approach (including a risk adjustment).
39. This approach would address the concerns of some respondents that a loss could be recognized on a potentially profitable contract. They note that if actual experience is in line with expectations at the start of the contract the risk adjustment will ultimately be recognised as profit. If, therefore, the risk adjustment is included in identifying onerous contracts a loss could be recognized on a potentially profitable contract simply because the cash flows may be uncertain prior to the coverage of the contract or prior to the occurrence of an adverse event.
40. Other staff believe that it would be inconsistent to exclude a risk adjustment when identifying onerous contracts but include it for measurement purposes. In addition, in situations where the risk adjustment is significant, this approach would result in onerous contracts not being recognised. Consequently, these staff recommend that the risk adjustment should be considered when identifying onerous contracts.
41. The staff acknowledge that including a risk adjustment when identifying onerous contracts will make the onerous contract test more difficult to apply. However, the staff note that if the Board accepts the recommendations made in this paper, it would only be necessary to perform an onerous contract test when facts and circumstances indicate it may be needed.

## Questions to the Board

| Question 3: Measurement of the onerous contract liability |
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| Do the boards agree onerous contracts identified in the pre-coverage period should be measured on a basis consistent with the measurement of the liability recognised at the start of the coverage period?<br><br>Similarly, onerous contracts identified under the premium allocation approach should be measured on a basis consistent with the measurement of the liability for incurred claims?<br><br>**IASB only**<br><br>Do you confirm that:<br><br>(a) measurement of the liability for onerous contracts should include a risk adjustment?<br><br>(b) the risk adjustment should be considered also when identifying onerous contracts? |

## Appendix A

### Excerpts from Agenda Paper 1/65 from Joint Board Meeting on 27 April 2011

The following excerpts are provided as support for the boards' previous tentative decision that an insurer should be required to test for onerous contracts when facts and circumstances indicate that the contract might be onerous under the premium allocation approach.

A1. Paragraph 60 of the IASB's ED states "an insurer shall update the measurement of the additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous." This would require the test to be performed each period.

A2. Many respondents noted that requiring the test to be performed each reporting period was burdensome and did not simplify the model. In most situations a contract will not be onerous. Some responded that the test should not be required to be performed each reporting period if qualitative factors did not indicate there could potentially be an onerous contract.

A3. A qualitative test to indicate whether certain types of assets may be impaired is used in both US GAAP and IFRSs. Those qualitative tests rely on factors or indicators to evaluate whether or not an asset is impaired. In IFRSs for example, IAS 36 *Impairment of Assets* requires an entity to assess at the end of each reporting period whether there is any indication that an asset may be impaired and provides examples of indicators (both internal and external). In US GAAP for example, long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that the carrying amount of those assets may not be recoverable. Topic 360, Property, Plant, and Equipment, provides examples of such events or changes in circumstances. Another example in US GAAP is for testing goodwill for impairment between annual tests (effective for public entities for fiscal years, and interim periods within those years, beginning after December

15, 2010). Under the pending content of Topic 350, Intangibles—Goodwill and Other, interim impairment testing for goodwill is needed only if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. That Topic also provides examples of such events or circumstances. US GAAP also provides (Topic 320, Investments—Debt and Equity Securities), examples of indicators of when an impairment of an equity security classified as available-for-sale may be other than temporary.

A4. While the guidance referred to above is for the assessment of the impairment of assets the reason for the qualitative criteria could be analogized to an assessment of an onerous liability. That is, there are numerous factors to be considered in an evaluation of impairment and their relative significance will vary from case to case. In addition, performing a full impairment test/onerous contract test could be costly and time consuming.

A5. Some of the guidance referred to above requires an annual impairment test regardless of indicators of impairment. Because of the nature of the types of contracts that would be eligible for the modified approach and that particular qualitative characteristics are strong indicators that insurance contracts are not onerous, the staff does not believe an annual impairment test is required.

A6. The staff considered several characteristics that could indicate that an insurance contract may be onerous:

a. Combined loss ratio[2] for the current year in-force business is in excess of 100%:

    i. It is a strong indicator that the pre-claims obligation is not onerous if the combined loss ratio for the current year in-force business in the claims period, when the "losses" are determined using the expected present value of the cash flows, is less than 100%.

[2] Combined loss ratio is generally defined as the sum of the ratio of losses and loss expenses to premiums earned (loss ratio) plus the ratio of statutory underwriting expenses to premiums written (expense ratio) after reducing both premium amounts by dividends to policyholders and is typically used by management to evaluate the performance of underwriting operations.

b. Significant increase in the frequency or severity of losses:

    i. while the combined loss ratio for the insurance liability in the claims period may be less than 100%, an indicator that the combined loss ratio may increase for a portfolio of contracts is if the claims being reported are more frequent or severe.

c. Characteristic of the risk profile of the business written has changed:

    i. a company that does not have sufficient historical experience with particular types of insurance may require a higher threshold to determine that a contract is not onerous.

A7. The staff believes that these qualitative factors, amongst others, could be an indication of whether or not a contract may be onerous and therefore whether or not the onerous contract calculation needs to be performed.

**Excerpts from Agenda Paper 3I/60I from Joint Board Meeting on 14 March 2011**

The following excerpts are provided as support for the boards' previous tentative decision that insurance contract assets and liabilities should initially be recognized when the coverage period begins and that an onerous contract liability should be recognized in the pre-coverage period if management becomes aware of onerous contracts during that period.

A8. Most respondents who opposed the proposed point of recognition suggested that insurers should recognise contracts only when the coverage period starts, or when a premium is received if earlier. In other words, (unless and until contracts become identified as onerous) the insurer should recognise no assets or liabilities before either party performs under the contract, ie while the contract remains executory. Respondents who sought to justify this 'performance' approach noted

that it would be consistent with the recognition requirements proposed in the exposure draft *Revenue from Contracts with Customers.*

A9. Some staff members recommend that an insurer should recognise an insurance contract asset or an insurance contract liability when the insurer is on risk, which typically will be the commencement of the coverage period, because they believe the requirement to "recognise" the insurance contract means the contract needs to be tracked and accounted for and:

a. the high cost to implement system changes necessary to evaluate that the impact is immaterial does not outweigh the benefits,

b. in most cases the impact on the financial statements would be nil (as described above),

c. the benefits to financial statement users, if any, would be low.

A10. Applying this alternative approach, the staff believe the insurer should still be required to recognise an additional liability if management became aware of an event that happened prior to the balance sheet date that would cause a portfolio of contracts in the pre-coverage period to have a material adverse impact on the financial statements and therefore should be reflected.