
Staff Paper

Project **Insurance contracts**Topic **Explicit risk adjustment**

What is this paper about?

1. This paper asks the boards to consider whether, in principle, an explicit risk adjustment provides useful and understandable information for users of financial statements.

Staff recommendation

2. The staff recommend that the boards conclude that, in principle, the inclusion of an explicit risk adjustment in the measurement of insurance liabilities would provide relevant information to users.
3. This paper does not consider whether a risk adjustment could be determined in a verifiable way that promotes comparability of financial statements, nor whether making the risk adjustment explicit would pass a cost-benefit test. This will be discussed at a future meeting.

Structure of paper

4. This paper provides:
 - (a) background, including summaries of:

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB 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 U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

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- (i) the IASB's proposals and the FASB's preliminary views on the inclusion of an explicit adjustment to account for risk arising from insurance contracts (paragraphs 6-14); and
 - (ii) feedback received from comment letters, informal outreach, roundtables, and field testing (paragraphs 17-24).
- (b) staff analysis including:
- (i) whether there is a need for an adjustment for risk (paragraphs 26-38).
 - (ii) whether explicit information about an adjustment for risk is useful and understandable (paragraphs 39-56).
 - (iii) whether an explicit risk adjustment is consistent with the proposals in ED *Revenue from Contracts with Customers* (paragraphs 57-59).
- (c) the implications that future topics to be discussed by the boards might have on the question of whether a risk adjustment should be explicit (paragraphs 60-63).
5. The following issues are not discussed in this paper:
- (a) Whether to include an explicit risk adjustment in the measurement of the insurance liability. We intend to ask the boards to make this decision in a future meeting after considering issues relating to comparability, verifiability and cost-benefit as well as other areas where uncertainty may be included in the measurement model.
 - (b) The drafting of the objective of a risk adjustment. Although we describe in this paper what we believe a risk adjustment represents, we will consider at a future date the drafting of the objective.
 - (c) The level of aggregation and the calculation techniques for determining a risk adjustment. These will be considered at a future meeting.

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Background

6. The boards differed in their conclusions about whether the measurement model should include an explicit risk adjustment:
 - (a) The IASB's Exposure Draft *Insurance Contracts* (the ED) proposes to include an explicit risk adjustment in the measurement of an insurance liability.
 - (b) The FASB decided not to include an explicit risk adjustment in the measurement of an insurance liability. In the FASB's Discussion Paper, Preliminary Views on Insurance Contracts (the DP), the FASB took the view that risk associated with the uncertainty in the net cash flows of an insurance contract should be reflected implicitly through a single composite margin.

Summary of the IASB's proposals and the FASB's preliminary views

7. The ED proposes that the measurement of an insurance contract liability should include an explicit adjustment to reflect the risk remaining in the contract. Paragraph 35 of the ED states:

The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.

8. Paragraph BC109 of the Basis for Conclusions of the ED provides the IASB's reasoning for including a risk adjustment in the measurement of insurance liabilities as follows:

In the Board's view, the resulting measurement would:

(a) convey useful information to users about the amount of risk associated with the insurer's insurance contracts because the management of risk is integral to the insurance business model.

(b) reflect the insurer's view of the economic burden imposed on it by the presence of that risk.

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(c) be broadly consistent with existing requirements in IAS 37, and with the refinements of, and extensions to, those requirements proposed in the exposure draft *Measurement of Liabilities* in IAS 37.

(d) reduce the amount of the residual margin for which a release pattern is somewhat arbitrary.

9. The FASB took a different approach in their preliminary views. Instead of including an explicit measure of risk in the measurement of the insurance liability, the FASB preferred to depict risk within a single composite margin. The FASB's preliminary view is that the pricing of the insurance contract reflects the risk and uncertainty about the net cash flows. Therefore, any uncertainty would be implicitly included in a single composite margin that also implicitly includes any potential profit.
10. The FASB board members that supported a single composite margin were concerned about the level of judgment required to determine the explicit risk adjustment and the loss of comparability that this might cause.
11. Therefore the FASB concluded that the single composite margin provided benefits that an explicit risk adjustment could not. Those benefits were expressed in paragraph 71 of the DP, as follows:

a. The approach would be more consistent with the allocated transaction price approach in the proposed Accounting Standards Update on revenue recognition, because both a composite margin and a residual margin are allocations of the customer consideration, whereas a risk adjustment margin would be subsequently remeasured.

b. A composite margin would eliminate the need to use subjective methods for measuring the risk adjustment margin that may decrease comparability. Furthermore, changes in those subjective measurements from period to period would be recognized immediately in earnings.

c. A composite margin would provide a simpler and more understandable approach to account for the difference between the expected cash inflows and outflows. The method for subsequent recognition of the composite margin in earnings would be simpler to calculate and more transparent to users of financial statements than the

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IASB’s proposed techniques for subsequent recognition of changes in the risk adjustment margin.

12. We discuss:
- (a) The consistency of an explicit risk adjustment with the transaction price allocation approach in the boards’ project on Revenue Recognition in paragraphs 57-59; and
 - (b) Whether a measurement approach that explicitly measures risk is understandable in paragraphs 50-53.
13. We will discuss the issue of subjectivity in the estimates at a future meeting.
14. Further differences arise between the models as a consequence of the decisions made by each of the boards. These differences are summarised in Table 1:

Table 1

	Explicit adjustment residual margin	risk (ie composite margin)
Type of measurement	Explicit	Implicit – embedded in the calibration of the EPV of cash flows to the initial pricing
Reporting of losses on day-one	Considers an adjustment for risk in assessing whether there is a loss on day one	Does not consider an adjustment for risk in assessing whether there is a loss on day one
How it reflects changes in risk	<ul style="list-style-type: none"> • Fully re-measured to reflect the price and quantity of risk at each reporting date • Reflects increases in risk that exceed the allowance for risk included in the initial pricing of the contract 	<ul style="list-style-type: none"> • Locked-in and allocated to profit or loss over coverage and claims handling period of contract. Thus, the change in uncertainty is reflected in the run-off of the margin and does not reflect changes in the price or quantity of risk. • Measurement of risk capped at the initial composite margin, which is calibrated to the initial pricing of the contract

Relevant questions in the Exposure Draft / Discussion Paper

15. Question 4 of the ED asked respondents the following:

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Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

16. The DP asked respondents the following:

Question 8: Do you think that an entity's estimate of the net cash flows should include a risk adjustment margin?

Question 15: Do you agree with the use of either the composite margin approach or two-margin approach to measure the net insurance contract? Does either approach faithfully represent the economics of insurance contracts? Is either approach an improvement over the measurement used in current U.S. GAAP?

Overview of comments on the Exposure Draft / Discussion Paper

17. Commentators had differing views on whether risk in an insurance contract should be represented explicitly, via an explicit risk adjustment, or implicitly, in a composite margin. The level of support for including an explicit risk adjustment in the measurement of an insurance contract liability varies along geographical lines. Respondents to the ED generally agreed with an explicit risk adjustment (some with specific caveats), in particular when they were from countries that will adopt Solvency II for regulatory capital purposes. (Solvency II requires an explicit risk adjustment using the cost of capital approach and would allow the residual margin to be included as part of capital.) Other respondents that are in favour of an explicit risk adjustment are in countries where an explicit risk adjustment is currently required to be calculated and recorded in accordance with specific guidance (eg., Australia and Canada). Those that responded to the DP (primarily U.S. respondents) generally did not agree that the adjustment for risk should be explicit.

Arguments in favour of an explicit risk adjustment

18. Some respondents to the ED and the DP argued that managing the variability in the amount and timing of cash flows – ie insurance risk – is the essence of the insurance business. Most commentators agreed that a measure of risk – or a risk adjustment – would be necessary because the expected value of the future cash flows does not

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measure the variability of the cash flows, ie how wide the range of possible scenarios is. Therefore they believe that explicit information about the insurance risk inherent in those liabilities is relevant to an economic valuation of insurance liabilities.

19. Some respondents also expressed a view that the identification of a separate risk adjustment would provide a better representation of an insurer's performance because it would provide information to users about:
 - (a) an insurer's perception of the riskiness characterising the contracts it issues;
 - (b) the compensation the insurer requires for bearing the risk;
 - (c) circumstances in which the premiums do not fully compensate the insurer for bearing that risk; and
 - (d) the remaining profitability which is embedded in the residual margin under the ED.
20. Some observed that an explicit risk adjustment would *clean up* the residual margin from the measurement of the insurance risk, thus reducing the extent to which it can be regarded as a *plug*.

Arguments against an explicit risk adjustment

21. The concerns about an explicit risk adjustment described by commentators include the following:
 - (a) An explicit risk adjustment is inherently subjective because it is not observable and judgement would be required for its calculation. Out of the context of a regulatory framework, the calculation of the risk adjustment would be inherently arbitrary. These factors may impair comparability and allow for potential manipulation of results, particularly since the lack of an observable adjustment would make it difficult to determine whether the assumptions were reasonable and the objective of its measurement were met.
 - (b) The explicit risk adjustment may not be understandable. Some argue that if one insurer recognised a larger risk adjustment than other insurers, it might

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be unclear whether that insurer had been conservative in making assumptions or genuinely had a different risk profile from the others. Others state that the complex tools required to calculate the risk adjustment might add complexity that the users will not understand and result in the quality of the accounting for insurance liabilities varying with an insurer's availability of resources to determine the risk adjustment.

- (c) An implicit, rather than explicit risk adjustment would be more closely anchored to the initial pricing of an insurance contract because the margin remaining after measuring the cash flows would be a single representation of the factors making up the insurer's profit. This includes compensation for risk and the recovery of overhead costs and non-incremental acquisition costs which are not included in the measurement of the cash flows.
- (d) A risk adjustment adds a bias to the measurement of insurance liabilities because it adds an extra layer of prudence to the measurement and may also give users a misleading impression about the precision of liability measurement.
- (e) The inclusion of an explicit risk adjustment for insurance contracts would be inconsistent with the approach adopted in the boards' project on revenue recognition because it remeasures, rather than allocates a portion of the customer consideration.
- (f) There could be significant set up costs required if the boards were to conclude that a risk adjustment shall be included in the measurement of insurance contracts.

Comments about the objective as drafted

- 22. Some were concerned that the objective of the risk adjustment as drafted would not be consistent with the notion of fulfilment value because the amount being determined as the value of risk would not ultimately be paid by the insurer in fulfilling the insurance contract. The ED describes the risk adjustment as an 'explicit estimate of the effects of uncertainty about the amount and timing of [the expected]

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future cash flows’ and states that the risk adjustment would be ‘the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected’. We address this concern in paragraphs 32-33.

23. Both those supporting an explicit risk adjustment and those opposing it questioned the clarity of the measurement objective established in the ED for the risk adjustment, as follows:
 - (a) Some believe that defining the risk adjustment as ‘the maximum amount the insurer would rationally pay’ implies the view of a market participant rather than of the insurer fulfilling the contract.
 - (b) Some thought that the notion of ‘maximum amount’ indicated that the insurer should use several techniques and select the one that produces the largest risk adjustment. (In the staff’s view, the boards did not intend that.)
 - (c) Some read the reference to cash flows in paragraphs 35 that ‘exceed those expected’ as implying that the risk adjustment should consider only scenarios when ultimate net cash outflows are more than the expected net cash outflows. However, others note that paragraph 22(c) suggests that ‘uncertainty’ also refers to scenarios when ultimate net cash outflows are less than the expected net cash outflows.
24. We see the points mentioned in paragraph 23 as drafting issues that we will address at a future date.

Staff analysis and recommendation

25. We analyse the merits of an explicit risk adjustment by considering:
 - (a) the need for an adjustment for risk (paragraphs 26-38);
 - (b) whether making the adjustment for risk explicit could provide useful and understandable information for users (paragraphs 39-56); and

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- (c) whether an explicit adjustment for risk is consistent with other requirements and the proposals in ED *Revenue from Contracts with Customers* (paragraphs 57-60).

About the need for an adjustment for risk

26. This section considers questions that commonly arise in the discussion about whether a risk adjustment for insurance liabilities is needed. It does so by answering the following questions:

- (a) Why include a risk measure on top of the present value of probability-weighted estimates of cash flows?
- (b) Is a risk adjustment needed under a fulfilment notion?
- (c) Do the other building blocks already capture a measure of risks for insurance liabilities?

(a) Why include a risk measure on top of the expected present value of cash flows?

27. A simple example illustrates why the exercise required to determine expected value in the first building block does not reflect the risk in the expected cash flows. Consider two contracts:

- (a) Contract A
 - (i) Claim payment – CU1,000,000 with a probability of 0.5
 - (ii) Claim payment – CU0 with a probability of 0.5
- (b) Contract B
 - (i) Claim payment – CU 500,000 with a probability of 1

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28. As **Table 2** shows, these two contracts have the same expected value:

Table 2

	Probability	Pay-off (CU)
A	0.5	1,000,000
	0.5	0
	(0.5 x 1,000,000)+(0.5 x 1,000,000) = CU500,000	
Probability-weighted average		
	Probability	Pay-off (CU)
B	1	500,000
	(1 x 500,000) = CU500,000	
Probability-weighted average		

29. If an insurer is indifferent to risk, the insurer would value the cash outflows for Contract A and Contract B at the same amount. However, a risk adverse insurer would give more weight to the unfavourable scenarios than to the favourable ones. Therefore a risk adverse insurer places a higher value on Contract B than on Contract A.

30. The same rationale as presented above applies in the context of discounted expected value cash flows. This concept is consistent with Statement of Financial Accounting Concepts No. 7 *Using Cash Flow Information and Present Value in Accounting Measurements* (CON7) which states:

20 The objective of using present value in an accounting measurement is to capture, to the extent possible, the economic difference between sets of future cash flows. [...]

21 [...] present value helps to distinguish between unlike items that might otherwise appear similar. A present value measurement that incorporates the uncertainty in estimated future cash flows always provides more relevant information than a measurement based on the undiscounted amounts or a discounted measurement that ignores uncertainty.

63 Present value measurements, like many other accounting measurements, occur under conditions of uncertainty. In this Statement, the term uncertainty refers to the fact that the cash flows used in a present value

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measurement are estimates, rather than known amounts. (Even contractual amounts, like the payments on a loan, are uncertain because some borrowers default.) That uncertainty has accounting implications because it has economic consequences.

Although CON7 was written in the context of a fair value measurement objective, the staff believe that the principle applies equally to the determination of the expected present value of cash flows under a fulfilment notion.

(b) Is a risk adjustment needed under a fulfilment notion?

31. Because of the uncertainty it is subject to, the insurer weights more to the ‘bad’ outcomes than to the ‘good’ outcomes. In other words, there is an economic burden imposed on the insurer by the presence of risk in the insurance contract. A risk adjustment tries to measure this economic burden.
32. The boards agreed that the measurement of insurance liability should consider the view of an insurer as it fulfils the contract. Under this view, the risk adjustment tries to measure the additional amount that a risk adverse insurer would require to persuade it to undertake to fulfil a liability with uncertain cash flows, as opposed to a liability with cash flows which are not subject to uncertainty.
33. We believe that assigning a value to reflect this additional amount is relevant under a fulfilment notion because the measurement of the liability reflects the point at which an insurer is indifferent between fulfilling the liability and paying to be relieved of the liability, rather than necessarily the current exit price. Similarly, it could represent the point at which an insurer is indifferent whether to undertake an obligation identical to its existing obligation under the existing liability. We will consider how to describe the objective of the risk adjustment in a future meeting.

(c) Do the other building blocks already capture a measure of risks for insurance liabilities?

34. As discussed in paragraphs 27-29 and agenda papers 2A/1A and 3F/58F, some staff believe a probability-weighted estimate of expected cash flows does not provide any information regarding the uncertainty that characterises those cash flows. Other staff

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believe there is implicit bias which includes the uncertainty in the contract in the calculation of the expected cash flows. We shall assume for this paper that an insurer can implement the principle that the cash flows included in expected value should be unbiased, and that any uncertainty is included in the risk adjustment.

35. The time value of money – ie the discount rate – could theoretically include an allowance for risk. However, paragraphs 33 of the ED explicitly states that:

Estimates of cash flows and discount rates shall be internally consistent to avoid double-counting or omissions. [...]

36. Furthermore, the proposed Application Guidance (B69-B70) indicates that no risks other than insurance risk shall be captured by the risk adjustment (unless investment risk affects the pay-off to policyholders) and that it shall not be included in the other building blocks:

[the risk adjustment] shall not reflect risks that do not arise from the insurance contract, such as investment risk (except when investment risk affects the amount of payments to policyholders), asset-liability mismatch risk or general operational risk relating to future transactions.

The risk adjustment shall be included in the measurement in an explicit way. Thus, the risk adjustment is separate from estimates of future cash flows and the discount rate that adjusts those cash flows for the time value of money; it cannot be included implicitly in those two other building blocks.[...]

37. Under an explicit risk adjustment approach, the residual margin cannot duplicate the allowance for risk because, by definition, it is what remains after the calculation of the present value of future cash flows and the risk adjustment. If the pricing of the contract includes an allowance for risk, the risk adjustment would capture it by explicitly measuring the risk inherent in the contract. In the situation where the allowance for risk embedded in the pricing exceeds the explicit risk adjustment, the difference would ideally represent profit for an insurer, to be recognised over the life of the contract in accordance with some driver to be specified in the standard.
38. Under a composite margin approach, the measure for risk is included implicitly in the composite margin. If the initial pricing of the contract contains an allowance for

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risk, the risk captured in the pricing is commingled with other elements that are factored in the pricing of the insurance contract.

About the usefulness of an explicit risk adjustment

39. In determining the usefulness of an explicit risk adjustment which is redetermined at each reporting period, we considered the boards' *Conceptual Framework for Financial Reporting* (the *Framework*) which states in QC4:

If financial information is to be useful, it must be relevant and faithfully represents what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

40. We note that the *Framework* also lists the four enhancing qualitative characteristics of useful information of: comparability, verifiability, timeliness and understandability. QC33 states:

Enhancing qualitative characteristics should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.

41. We will adhere to the approach set out in QC18 of the *Framework*:

The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the enhancing qualitative characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented.

42. Therefore, this paper considers first whether information about a risk adjustment has the potential to be useful to users of the reporting entity's financial information. In other words, this paper considers whether an explicit risk adjustment is relevant and capable of being faithfully representational. We plan to discuss the enhancing characteristics at a future meeting before concluding whether requiring an explicit

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risk adjustment would provide information that is useful, subject to costs constraint. However, because the DP specifically criticises the understandability of the risk adjustment, we will also discuss in this paper how that characteristic applies to an explicit risk adjustment.

A risk adjustment provides relevant information

43. Financial information is relevant if it has predictive value, confirmatory value or both.
44. As discussed in paragraphs 27-0, an adjustment for risk provides information about the effect of uncertainty in the amount and timing of the estimated projected future cash flows. We do not believe that a risk adjustment would add *confirmatory value* to the measurement of insurance contracts. However, in the staff's view if this adjustment were made explicit, it would add *predictive value* to the measurement of insurance liabilities. QC8 of the *Framework* state that:

QC8 Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

45. Furthermore, when describing the objective, usefulness and limitations of general purpose financial reporting, the *Framework* states:

OB3 Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and **uncertainty** of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity (emphasis added).

46. Information about the uncertainty arising from insurance contracts cash flows and the insurer's assessment of the related risk should be a critical input to the processes employed by users to predict future outcomes because of the importance to an insurer of managing risk. In the staff's view, an explicit adjustment for risk would

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therefore enhance a user's ability to obtain predictive value by increasing the visibility and transparency of this information.

A risk adjustment provides faithfully representational information

47. Financial information should faithfully represent the phenomena that it purports to represent. Some question whether a risk adjustment could provide a faithful representation because of the uncertainty in estimating it. However, the *Framework* specifically discusses whether an estimate is capable of faithful representation as follows:

QC15 Faithful representation does not mean accurate in all respects. Free from error means that there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

48. A variety of techniques for determining a risk adjustment exist and we will consider the techniques used in more detail at a future meeting. If there are techniques that could faithfully represent the risk inherent in insurance liabilities, then information about the risk in a contract and the insurer's assessment of the risk is capable of faithful representation. However, the staff note that the *Framework* also warns:

A faithful representation, by itself, does not necessarily result in useful information. [...] [An] estimate can be a faithful representation if the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.

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49. Although we assume that an explicit risk adjustment is capable of faithful representation we will consider further the usefulness of the explicit risk adjustment in the light of the level of uncertainty about its determination. We will consider in a future meeting an assessment of the level of uncertainty in the estimate of an explicit risk adjustment, together with an analysis of how the enhancing characteristics of comparability and verifiability would apply.

A risk adjustment provides understandable information

50. The FASB's DP stated that a composite margin would provide a simpler and more understandable approach to account for the difference between the expected cash inflows and outflows. It also states that its proposals for subsequent recognition of the composite in profit or loss would be simpler to calculate and more transparent than the IASB's proposed techniques for subsequent recognition of changes in the risk adjustment margin. Concerns about complexity and understandability were also raised in the comment letters to both the ED and the DP.
51. However, in some of the staff's view, that view appears to combine understandability about the techniques used to determine an explicit risk adjustment with the outcome of those techniques. Those staff believe an explicit risk adjustment helps, rather than hinders, the understandability of information about the measurement of an insurance contract because it indicates changes in the risk by reporting changes in the risk adjustment. One does not need to understand the workings of an internal combustion engine to drive a car. As noted in QC30 "classifying, characterising and presenting information clearly and concisely makes it understandable" and a separate and explicit measure of risk be a necessary first step in classifying and characterising that information.
52. Furthermore, it would exclude information about risk if the boards did not make the adjustment for risk explicit. We believe that the disadvantage of an implicit, rather than explicit risk adjustment are well articulated in QC31 and QC32:

QC31 Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those

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reports would be incomplete and therefore potentially misleading.

QC32 Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

53. In the staff's view, the boards need to balance the need for information that is simple against the need for information that provides insight into a defining, although inherently complex, characteristic of an insurance contract, ie insurance risk. Any complexity added by an explicit risk adjustment does not preclude that information from being understandable and some might argue that this complexity is more informative than simplicity that does not really exist.
54. Other staff believe that due to the various calculations for a risk adjustment, none of which have been proven to be comparable, as well as the fact that the risk adjustment is not observable and therefore one cannot determine whether it was measured appropriately or whether the measurement met the objective, an explicit risk adjustment that is arbitrary and not verifiable could hinder rather than help the understandability about the measurement of an insurance contract. These staff believe further analysis needs to be performed before concluding on whether an explicit risk adjustment helps the understandability of the measurement of an insurance contract.

Staff recommendation

55. In paragraphs 43-53, we argue that explicit information about risk is relevant and, capable of providing a faithful representation. This means that an explicit risk adjustment satisfies the fundamental qualitative characteristics in the *Framework*. Some staff also believe an explicit risk adjustment adds understandability to the depiction of insurance transactions.
56. However, we do not discuss at this meeting the effects of the enhancing characteristics and the cost constraint and therefore **we do not ask the boards**

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whether to require an explicit risk adjustment. Instead, the question we ask the boards is:

Explicit risk adjustment

If there are techniques that could faithfully represent the risk inherent in insurance liabilities, do the boards agree that, conceptually, the inclusion of an explicit risk adjustment in the measurement of insurance liabilities would provide relevant information to users?

Do the boards also agree that conceptually, the measurement of an explicit risk adjustment can add to the understandability of the measurement of insurance liabilities?

(We will ask the boards at a future meeting whether a risk adjustment could be determined in a verifiable way that promotes comparability of financial statements and whether making the risk adjustment explicit will pass a cost-benefit test. At that point, the staff will ask whether the boards will require an explicit risk adjustment.)

About the consistency of an explicit adjustment for risk with the ED Revenue from Contracts with Customers

57. The DP stated that a single composite margin would be more consistent with the approach adopted in the boards' project on revenue recognition because it allocates, rather than remeasures the risk portion of the customer consideration.
58. However, we note that the Revenue ED and the Insurance Contracts ED have different models:
 - (a) In *Revenue from Contracts for Customers* the board proposed a transaction price allocation approach.
 - (b) In *Insurance Contracts* the boards proposed a liability measurement model, with a price allocation overlay to calibrate the measurement of the liability to the consideration received or receivable.
59. Neither a residual margin approach and a composite margin approach is consistent with the revenue recognition model in its entirety. Only part of the premium (or customer consideration) is allocated over the life of the contract. The remainder is assigned to the measurement of the liability. Therefore, we do not believe that the

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comparison between the allocated portion of the premium and the revenue recognition model is relevant.

Potential implications of future topics

- 60. As described in paragraph 42, we will consider whether an explicit risk adjustment should be required at a future meeting.
- 61. Agenda paper 3L/58L provides material for a non-decision-making session on the possible unlocking of the residual/composite margin. We will consider in a future meeting whether a residual or composite margin should be unlocked and what the pattern of allocation of the margin might be.
- 62. However, we note that future decisions on how to unlock or allocate the residual or composite margin could have significant implications for the importance of the decision about whether a risk adjustment should be explicit or implicit. In particular, there might be little relevance to the question of whether the risk adjustment is explicit or implicit, if the following approaches were adopted:
 - (a) In an explicit risk adjustment approach, the residual margin in the IASB proposals could be unlocked and recalibrated to reflect changes in the risk adjustment.
 - (b) In an implicit risk adjustment approach, the composite margin under the FASB’s proposals could be allocated in a way that reflects the pattern of change of risk (including when risk increases) or could be unlocked to reflect changes in the uncertainty in the contract.
- 63. Because the pattern of release of any margin plus a risk adjustment (either explicit or implicit) would under both approaches in paragraph 62 follow changes in risk, the overall effect would ultimately be similar.

Discussion point

We would like to ask Board members for their initial reactions to this proposal.