IASB/FASB Meeting
Week commencing 14 March 2011

IASB Agenda reference **3I**

Staff Paper

FASB Agenda reference **60I**

Project **Insurance contracts**

Topic **Timing of initial recognition**

Paper overview

1 This paper considers comments on the proposals regarding the timing of initial recognition of insurance contract assets and liabilities.

Staff recommendation

2 The staff recommend that the Boards:

(a) reaffirm the principle proposed in the exposure draft, ie that an insurer should recognise an insurance contract asset or liability from the date on which it becomes a party to the contract; but

(b) emphasise that insurers need not change their accounting systems to recognise insurance contract assets and liabilities before the start of the coverage periods if those assets and liabilities—and any gains or losses that arise before the start of the coverage period—would not be material to the financial statements.

Alternative view

3 Some staff members disagree with this recomendation. They favour instead an approach that would defer the recognition of all insurance assets and liabilities until the coverage period begins, and the recognition of an onerous contract if management becomes aware of an onerous contract in the pre-coverage period.

Background and introduction

IASB exposure draft and FASB discussion paper proposals

4 The IASB exposure draft and FASB discussion paper proposed the same requirements regarding the timing of initial recognition of insurance contract assets and liabilities. The exposure draft stated that:

> ### Recognition
>
> **13 An insurer shall recognise an insurance contract liability or an insurance contract asset when the insurer becomes a party to the insurance contract.**
>
> 14 An insurer becomes a party to an insurance contact on the earlier of the following two dates:
>
> a. when the insurer is bound by the terms of the insurance contract, and
>
> b. when the insurer is first exposed to risk under the contract, which is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk.

5 An insurer could be bound by the terms of, or first exposed to risk under, a contract at various times, depending on the nature of the contract, eg:

(a) as soon as the insurer has offered coverage to potential policyholders, if that offer (including the price) is binding on the insurer;

(b) only once the contract is in place—ie once the policyholder has accepted the contract—if the insurer can withdraw or re-price its offer before then; or

(c) only once coverage starts, if the insurer can cancel or re-price the contract before then.

6 Consequently, recognition would be required at different times, depending on the facts and circumstances.

Implications of proposed requirements

7 At present, many insurers first recognise insurance contract assets and liabilities at a later date than that proposed in the exposure draft. For example:

(a) some insurers recognise the assets and liabilities only once a contract is in place (even if a binding offer has been made before then); and

(b) others recognise the assets and liabilities only when coverage commences or when a premium is received if earlier.

8 Consequently, the proposals could require some insurers to recognise and measure contract assets and liabilities earlier than they do at present, and when they have less information available about the extent of their obligations. The costs of implementing the proposals could be significant. In some cases, the effects of the change would not be material.

Overview of comments received

9 Most respondents did not comment on the recognition requirements.

10 A few respondents—regulators and actuaries— explicitly supported the proposals ‘on theoretical grounds’.

11 Some respondents opposed the proposals, on the grounds that the costs of recognising insurance contract assets and liabilities before the start of the coverage period would exceed the benefits. Their comments are discussed in paragraphs 13-38 of this paper.

12 Some respondents also questioned the wording of the requirements. Their comments are discussed in paragraphs 40-47 of this paper.

Issue 1: Costs outweigh benefits

Comments on exposure draft proposals

13 Some respondents opposed the proposed point of recognition on practical grounds. These respondents were mainly preparers of financial statements from across the insurance industry (mainly in the US), but they also included a few actuaries and some large accounting firms. The feedback we have received is that the matter is of most concern to reinsurers and

healthcare insurers, who would be more affected than other types of insurers by the proposed changes.

14 Respondents opposing the proposed requirements argued that a requirement to recognise insurance contracts before the start of the coverage period would:

(a) necessitate expensive systems changes.

(b) make on-going record-keeping more difficult because it would require insurers to record data before it was readily available. For example, insurers might not be aware of all contracts sold by brokers or renewal options accepted by existing policyholders.

(c) add complexity by imposing requirements:

(i) to make adjustments when actual acceptance rates (inevitably) differed from those expected at initial recognition; and

(ii) to make adjustments to avoid duplication in the measurement of liabilities when an insurer offers a renewal contract (for example for home or motor insurance) before the previous contract has expired; and

(iii) to evaluate the terms of contracts to identify the point at which the insurer becomes bound by each contract. The answer could vary from one jurisdiction to another.

15 Respondents argued that any benefits to users from changing the point of recognition would not outweigh the costs of changing systems and gathering data at an earlier stage:

(a) the net amount initially recognised for profitable contracts would typically be nil, because no premium would typically have been received at the time of initial recognition.

(b) furthermore, for some insurance contracts any gains or losses in the pre-coverage period are unlikely to be significant. For example, the claims level of healthcare providers tend to be relatively stable at a portfolio level—they are not exposed to significant catastrophe risk and so are not vulnerable to changes in assessments of that risk.

(c) insurance contracts do not expose the insurer to risk in the pre-coverage period.. Exposure to risk will arise only if the insured asset still exists in the same form at the start of the coverage period as when the contract was written. An insurer might never be exposed to risk from providing motor insurance if the insured vehicle is damaged beyond repair before the start of the coverage period.

(d) consequently, recognising such contracts before the coverage period starts is unlikely to provide any useful additional information to users of financial statements;

(e) the adjustments required for differences between expected and actual acceptance rates would be confusing for financial statement users.

16 Some respondents also argued that insurers might be unable to measure their liabilities reliably when they make binding offers because acceptance rates would be uncertain. Respondents gave examples of specific contracts for which this might be a problem:

(a) *group insurance products*: during an open enrollment period, which might last for several months before coverage commences, individuals from the group may or may not choose to be covered by the contract. Before the open enrollment period, the insurer underwrites the group as a whole and fixes a premium that it thinks represents the risk of the group. An insurer might not have enough information to estimate the future cash flows reliably at that time because it does not know how many individuals will enroll. The insurer might also not know the premiums that it will receive for each individual because the premiums might depend on the numbers that enroll. Subsequent adjustments would be required when the numbers enrolling became more certain.

(b) *reinsurance treaties*: reinsurers underwrite future new business of another insurer several months in advance of that other insurer writing the underlying direct contracts. In the case of automatic reinsurance, the reinsurer is bound to accept all amounts written by the insurance company up to a predetermined maximum (the binding authority).

(c) *shared risk contracts:* where a number of underwriters may be invited to cover a share of a single risk. Each insurer offers to underwrite a maximum percentage of the risk. Only when the broker has completed the placement will the various insurers know their share of the risk.

17 Some respondents noted that, because insurers sometimes reinsure new business before they have written it, these insurers (the cedants) might have to recognise reinsurance contracts they hold (including, in some cases a gain) before recognising the contracts that will be covered by the reinsurance.

Alternatives suggested by respondents

18 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*.

19 A few respondents suggested requiring recognition of contracts only once they have been accepted by policyholders, on the grounds that contracts should not be recognised before they come into existence.

20 One respondent suggested allowing insurers a choice of accounting policy—ie recognising contracts either when they become bound to them *or* when the coverage period begins—with a requirement to apply the chosen policy consistently.

Staff analysis

Reasons for re-affirming the proposed recognition requirements

21 The recognition point proposed in the exposure draft is consistent with the rest of the accounting model proposed for insurance contracts. The model aims to recognise and measure the obligations (and associated benefits) arising from the acceptance of insurance risk. To be consistent with this model, an insurer should recognise its obligations from the time at which it accepts that risk.

22 There is a rationale for the difference between the recognition point proposed for insurance contracts and that proposed for other revenue contracts in the exposure draft *Revenue from Contracts with Customers*. The difference is explained by the differences in the overall accounting models. The accounting model for *other* revenue contracts focuses on measuring performance. So, consistently with that model, an entity recognises no rights or obligations until one party has performed under the contract. In contrast, the accounting model proposed for *insurance* contracts focuses on measuring the obligations accepted by the insurer. So, consistently with that model, the insurer recognises its obligations as soon as they arise.

23 Some believe the alternative points for recognition proposed by some respondents would introduce new practical difficulties, because these recognition points are not consistent with the *measurement* requirements proposed for insurance contracts:

(a) *if contracts were recognised only when the coverage period started there might be diversity in the treatment of future coverage*

The proposed measurement model requires insurers to include cash flows relating to future years' coverage if the insurer is obliged to provide the future coverage without having the ability to reassess and re-price the risk. If contracts were recognised only from the start of the coverage period, the recognition and measurement of cash flows relating to that future coverage would depend on whether the future coverage was viewed as part of the same contract as the earlier coverage. Questions would arise as to the circumstances in which contracts for future coverage could or should be viewed as separate from contracts for immediate coverage.

(b) *if contracts were recognised only once they had been accepted by the policyholder, there might be inconsistencies in the treatment of renewal options*

The proposed measurement model requires insurers to include the expected cash flows from policyholder renewal options if the insurer does not have the right to set a price that reflects the risk at the time of renewal. If contracts were initially recognised only when accepted by the policyholder, the recognition and measurement of such policyholder options would depend on whether the options were viewed as options to extend an existing contract or to accept a new contract. Questions would arise as to the circumstances in which such renewal contracts could or should be viewed as separate from the preceding contracts.

Another way of addressing the practical difficulties – reference to materiality

24 An alternative course of action, which could help to alleviate the perceived practical difficulties, would be to refer to materiality in the standard.

25 In some cases, the assets and liabilities that arise before the receipt of a premium or the start of the coverage period are immaterial:

(a) this will *always* be the case for profitable short-duration contracts accounted for using the modified measurement model described in paragraphs 55-60 of the exposure draft. Applying the modified measurement model, the pre-claims asset or liability is measured at nil until a premium is received (or until an incremental acquisition cost is paid, if earlier) or the contract is identified as onerous.

(b) the pre-coverage assets and liabilities may also be immaterial for longer duration contracts accounted for using the standard measurement model. If a contract is recognised before any cash flows occur, the initial estimate of the 'present value of the fulfilment cash flows' for profitable contracts is an asset equal to the residual/composite margin. Consequently, the net amount initially recognised (ie the asset less residual/composite margin) is nil.

(c) furthermore, there will be no significant changes in this amount between initial recognition and coverage commencing or a premium being received unless there are significant changes in expected cash flows or interest rates during that period. For some types of insurance, the likelihood of material changes at the portfolio level is very low. For example, it is typically low for life insurance contracts because the period between the insurer becoming a party to a contract and the coverage commencing is typically very short.

26 The IASB tries not to refer to materiality in individual IFRSs, to avoid any inference that materiality is relevant only when explicitly mentioned. However, the insurance exposure draft referred to materiality in the context of the measurement requirements: paragraph 21 noted that 'in many cases, the measurement of insurance contracts does not change materially after initial recognition before the start of the coverage period'. A similar reference to materiality within the recognition section might make it clearer that insurers may consider materiality in determining whether they need to change their systems to recognise insurance contract assets or liabilities before the coverage period starts.

Potential difficulties with a materiality approach

27 If an insurer's assets and liabilities do not become material until coverage starts or cash is paid or received under the contract, the insurer would *not* need to change its existing practices to comply with the proposed recognition requirements. However, some insurers may believe they would need to track and account for these policies in order to demonstrate that the impact is not material. Doing so could require costly system changes with little benefit.

28 In addition, although the net amount initially recognised is nil, the proposal may require disclosure of the gross components of the contract liability and the roll forward of such activity which may be material and in some situations may be different from the actual amounts (based on whether or not the policyholder accepts the contract or the asset exists at the coverage effective date). Again, the insurer may need to track and account for these policies in order to evaluate materiality for the disclosure.

29 For insurers that believe they would need to track and account for immaterial pre-coverage assets and liabilities, the alternative 'performance' approach proposed by some respondents could be less onerous. These insurers would still need to monitor their pre-coverage obligations. However, they would not need to recognise or measure any assets or liabilities unless changes in expectations or discount rates led them to believe that pre-coverage contracts had become loss-making. They would not need to track contracts individually. Rather, they could undertake higher level reviews to identify portfolios of pre-coverage obligations for which the fundamental pricing used to establish the contract is no longer appropriate, thus indicating a need to recognise an additional liability.

30 Incidences of contracts becoming onerous during the pre-coverage period could be relatively rare for some insurers. Changes in some variables could be significant—for example:

(a) if the probability of a hurricane or similar catastrophe suddenly increases;

(b) if a demand surge after a major hurricane inflates the prices of building materials, or

(c) if there is an unexpected increase in medical costs that impact specific health insurance contracts.

However, insurers are likely to have factored the possibility of these adverse outcomes into their previous models. If the probability of these outcomes increases, the expected value of the outflows might increase to some extent. However, such changes in individual variables might not often have such a significant impact on the overall expected value of the cash flows to cause whole portfolios to be identified as loss making.

Another option considered but rejected by the staff

31 The staff considered another option, whereby an insurance contract would be accounted for as a forward contract (a derivative) in the pre-coverage period. However, this option has no obvious advantages over the requirements proposed in the exposure draft:

(a) it would still require extensive tracking of policies in the pre-coverage period;

(b) the value would be difficult and costly to reliably determine, and possibly immaterial for reasons discussed above; and

(c) there would not be significant value to users of financial statements because:

(i) new policies are a routine part of an insurers ongoing business;

(ii) a value could not easily correlate to the level of exposure committed to by the insurer; and

(iii) a value could not easily correlate to any new risks within the exposure committed to by the insurer.

32 The boards considered but rejected this option when developing the exposure draft. No respondents suggested that they would prefer it to the proposed recognition requirements.

33 Those staff also considered whether there could be an analogy to loan commitments: changes in market variables (eg., the interest rate) would not be recognised prior to the commitment being drawn upon and a reduction in value would not be recognised prior to the commencement of the loan. The analogy would hold that the measurement of an insurance

contract in the pre-coverage period should not be impacted by changes in discount rate and a loss should only be recognized to the extent the contract was determined to be onerous.

34 However, the rationale for the requirements for loan commitments could not be applied to the proposed model for insurance contracts. The rationale for not remeasuring (some) loan commitments is explained in paragraph BC16 of IAS 39 *Financial Instruments: Recognition and Measurement*. The rationale is that entities do not remeasure the loans once issued. Rather, they measure the loans at historical cost and recognise changes in value only if and when the loans become impaired. The requirements for loan commitments are consistent with the treatment of the subsequent loans. In contrast, similar requirements for binding offers of insurance coverage would not be consistent with the subsequent accounting for the insurance contract when coverage commences.

Staff conclusions and recommendations

35 The staff share a view that the boards should avoid introducing requirements that force insurers to make complex and onerous changes to their systems to recognise immaterial assets and liabilities. However, different staff members have reached different views on *how* to avoid such a situation.

Staff recommendation

36 The view of some staff members forms the basis of the staff recommendation. The staff recommendation is that the boards should reaffirm the *principle* that an insurer should recognise an insurance contract asset or liability when the insurer becomes a party to an insurance contract. However, the boards should also emphasise that insurers need not change their accounting systems to recognise insurance contract assets and liabilities before the start of the coverage periods if those assets and liabilities—and any gains or losses that arise before the start of the coverage period—would not be material to the financial statements.

37 Staff members who support the staff recommendation do so on the grounds that:

(a) the existing recognition principle is consistent with the rest of the proposed model for insurance contracts, and in particular with the proposed measurement requirements. As discussed in paragraphs 21-23 of this paper, changing the recognition principle would lead to inconsistencies between the recognition and measurement requirements, which could give rise to diversity in practice, especially in the treatment of future coverage and renewals options. The more internally consistent the model is, the less vulnerable it will be to inconsistencies in interpretation.

(b) in many cases (including all short-duration contracts), an insurer should be able to demonstrate without tracking individual contracts that its pre-coverage assets and liabilities are not material. In more borderline cases, the insurers may need to monitor their pre-coverage obligations to make sure that they identify any portfolios in which the assets or liabilities become material. However, in such cases, the procedures might be similar to those required to identify onerous portfolios. At the other extreme, if pre-contract assets and liabilities are routinely material, applying the standard measurement model from the outset might be easier than applying an onerous contract model until coverage begins, and the standard measurement model thereafter.

(c) burdensome requirements to disclose gross amounts (which might be material even if the net amounts recognised are not material) could be avoided. We could address this matter when the boards revisit the disclosure requirements.

Alternative view

38 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.

39 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.

Questions for the boards

Question 1: recognition requirements
The staff recommend that the boards: - reaffirm the *principle* that an insurer should recognise an insurance contract asset or liability when the insurer becomes a party to an insurance contract, but - emphasise that insurers need not change their accounting systems to recognise insurance contract assets and liabilities before the start of the coverage periods if those assets and liabilities—and any gains or losses that arise before the start of the coverage period—would not be material to the financial statements. Do you agree with this recommendation? If not, do you support the alternative view?

Issue 2: Requirements are unclear

40 If the boards agree with the staff recommendation in the previous section, the staff will ask the boards to consider comments on the wording of the proposed requirements.

Exposure draft proposals

41 The exposure draft described the point at which an insurer becomes a party to an insurance contract as:

> … the earlier of the following two dates:
>
> a. when the insurer is bound by the terms of the insurance contract, and
>
> b. when the insurer is first exposed to risk under the contract, which is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk.

42 The boards included subparagraph b. to address situations in which an insurer might be exposed to risk before it has accepted an application for coverage. In some circumstances, the insurer is required to provide temporary coverage while it decides whether to issue or deny a longer-term contract to the applicant. It therefore becomes exposed to risk before it has become bound by the terms of the longer-term contract.

Comments received from respondents

43 Several respondents questioned the purpose of specifying two different dates for recognition. They were unable to understand how an insurer could be bound by the terms of the contract and *not* be exposed to risk under the contract (as exposed to risk was defined), and hence regarded either subparagraph a. or subparagraph b. as redundant.

44 Many other respondents commenting on the recognition requirements did not question their meaning, but appeared to misunderstand the purpose of subparagraph b. These respondents

appeared to think that it referred to the start of the coverage period, which would always be later than the date on which the insurer became bound by the terms of the contract.

45 Some respondents asked for more guidance, specifically on the meaning of 'bound'. They asked whether an insurer is bound by a signed insurance contract, a signed slip detailing the key terms or an email between the parties? One respondent asked whether and how an insurer would need to recognise assets or liabilities on making a binding offer to a broker. Another said that in the property and casualty insurance industry, the term 'bound date' refers to the date on which the contract is accepted and in place, even if it can subsequently be cancelled or modified.

Staff conclusions

46 The staff agree with respondents who think that there is some element of duplication in the requirements.

47 We also think that we could make the requirements clearer by expanding them slightly. Accordingly we suggest the following drafting changes:

Recognition

15 **An insurer shall recognise an insurance contract liability or an insurance contract asset when the insurer becomes a party to the insurance contract.**

16 An insurer becomes a party to an insurance contact ~~on the earlier of the following two dates:~~

~~a. when the insurer is bound by the terms of the insurance contract, and~~

b. ~~when the insurer~~ <u>when it</u> is first exposed to risk under the contract. It is first exposed to risk when it can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk.

<u>16A The point at which an insurer is first exposed to risk under a contract depends on the facts and circumstances. It might, for example, occur:</u>

<u>a when an insurer makes a binding offer of coverage.</u>

<u>b when a policyholder accepts an offer of coverage, if the insurer can withdraw its offer or re-price the coverage before then; or</u>

<u>c when the insurer receives an application for coverage, if the application obliges the insurer to provide temporary coverage until it has accepted or declined longer-term coverage. In such situations, the insurer is exposed to the risks of the temporary coverage.</u>

<u>16B However, in many cases, insurance contract assets and insurance contract liabilities—and changes in those assets and liabilities—are not material until either the coverage period starts or cash is paid or received by the insurer. In such cases, the insurer need not recognise insurance contract assets and liabilities until the coverage period starts or cash is paid or received.</u>

Question for the boards

Question 2: drafting clarifications
Do you agree that the requirements need to be clarified? If so, do you have any comments on the staff's suggested clarifications?

APPENDIX – OTHER COMMENTS

The table below lists other comments received on the proposed recognition requirements, along with a staff response explaining why no further action is proposed.

We do not intend to discuss these comments in the meeting unless requested to do so by a Board member.

	Comment	Staff response
1	Changes in expectations before coverage commenced would affect net income even before the insurer had performed any services. This outcome would be inconsistent with the proposals for residual margins, the purpose of which is to prevent any 'day 1' gain.	The purpose of the proposed requirements for residual margins is to avoid immediate recognition of the overall profit for providing services. The purpose is not to prevent recognition of changes in expectations before the contract commences. The boards will discuss remeasurement of the residual margin at a future meeting.
2	Any changes in estimates between the date of initial recognition and the start of the coverage period should be recognised as an adjustment to the residual margin instead of in net income. Volatility before the coverage period commences does not reflect the substance of an insurance contract.	There is no conceptual reason for treating adjustments to the present value of the fulfilment cash flows differently depending on whether coverage has yet commenced. Furthermore, such a requirement would complicate the accounting. The boards will discuss remeasurement of the residual margin at a future meeting.
3	Insurers should not recognise liabilities for contracts that they could cancel or reprice if the insured risk changes (for example if a home insurance policyholder starts to conduct a business from the home).	Insurers do not in these circumstances have the ability to cancel or reprice the existing contract. They should recognise a liability.

	Comment	Staff response
4	If insurers were required to recognise liabilities before the start of the coverage period, their legal obligations might change. They might be viewed as liable for losses that occur before the coverage period commences.	They will have contracts limiting their liability to the coverage period. It seems unlikely that a change in the date of recognition would lead to a change in the legal consequences.
5	For group schemes with set benefit periods (such as medical schemes with a January to December benefit period), the proposals would require insurers to recognise contracts for individual members at different times, depending on when each member enrolled (by indicating preferences). If this were the case, the requirements: • would lead to different measurements for similar liabilities within the same scheme; and • could require the insurers to recognise onerous contracts more frequently. They might need to do so if the members with worse risk profiles indicated their preferences earlier than the members with better risk profiles. Any additional onerous contract liabilities would put further pressures on the insurer's solvency levels.	The insurer would not recognise each contract on enrollment. Rather, the insurer would recognise an asset or liability (if material) on the basis of the expected number of the expected number of enrolments estimates during the enrollment period.