IFRS

**IASB/FASB Meeting 1-2 March 2011**

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| IASB Agenda reference | **2D** |
| FASB Agenda reference | **59D** |

# Staff Paper

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| Project | **Insurance contracts** |
| Topic | **Scope** |

## What is this paper about?

1. This paper discusses the scope of a standard on insurance contracts, other than:

   (a) financial guarantee contracts, as defined in IFRSs. Those contracts are discussed in paper 2E/59E.

   (b) financial instruments containing a discretionary participation feature. We will consider whether such instruments should be in the scope of a standard on insurance contracts at a future meeting.

## Staff recommendation

2. The staff recommend the boards:

   (a) narrow the scope exclusion proposed in the ED to exclude from the scope of the insurance contracts standard fixed-fee service contracts that have as their primary purpose the provision of services and that ~~do not~~ qualify for the modified approach for short-duration contracts.

   (b) confirm the remainder of the scope exclusions proposed in the IASB's exposure draft (ED) Insurance Contracts and the FASB's discussion paper (DP) *Preliminary Views on Insurance Contracts.*

## Background

3. The ED/DP proposed that a standard on insurance contracts should apply to insurance contracts, other than:

   (a) product warranties issued by a manufacturer, dealer or retailer.

   (b) employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans.

   (c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item.

   (d) residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease.

   (e) fixed fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event, for example maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction.

   (f) contingent consideration payable or receivable in a business combination.

   (g) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder).

4. We plan to discuss at a future meeting the definition of an insurance contract.

5. The relevant extracts of the ED and DP are provided in Appendices A-C.

### *Comments from respondents*

6. Question 11 of the ED asked respondents the following:

> b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

7. Question 3 of the DP asked respondents the following:

> a) Do you agree with the proposed scope exclusions? Why or why not?

8. Question 4 of the DP asked respondents the following:

> a) Should benefits that an employer provides to its employees that otherwise meet the definition of an insurance contract be within the scope of the proposed guidance? Why or why not?

9. About half the comment letters addressed the scope exclusions. Of those, most respondents agreed with the scope exclusions listed in paragraph 3 of this paper because they believe that the excluded items can properly be addressed under existing standards, other than for fixed-fee service contracts (see paragraphs 12 to 29).

10. Some believe that the boards should address policyholder accounting, either separately or as part of this project. It is beyond the scope of this project to address policyholder accounting and we defer consideration of whether policyholder accounting should be considered by the boards to a future board agenda decision.

11. In addition, the majority of respondents to the FASB DP commented that employer-provided health care benefits should not be included in the scope because health care benefits are generally considered a form of employee benefits and therefore compensation costs. However, a few respondents want clarification on treatment of some insurance coverage to employees of insurance entities in which the premium charged to the employee is equivalent to the premium charged to third-party employees and insurance contracts issued to the insurer's defined benefit plan (typically an annuity with investments in separate accounts) and corporate-owned life insurance, both when the executive is employed and after termination or requirement. The staff plans to consider this issue in drafting.

*Fixed fee service contracts*

12. Some note that there is little distinction between the benefits received under fixed fee service contracts and under many insurance contracts. Some disagreed that the boards should exclude some fixed-fee service contracts from the scope of the insurance contract standard because that would be a rules-based exception to the principle that all contracts that meet the definition of insurance contacts should be included within the scope of the insurance contracts standard.

13. Some of those commenting support the proposal that some fixed-fee contracts should be excluded from the scope of the insurance standard and accounted for under the revenue standard because they believe that:

    (a) the accounting for insurance contracts is not suitable for entities whose main activity is not insurance,

    (b) accounting for these contracts as revenue contracts provides relevant information for users of the financial statements of the entities that issue such contracts, and

    (c) changing the existing basis for accounting for these contracts would impose costs and disruption for no significant benefit.

14. Furthermore, many respondents request more clarity as to which fixed fee service contracts are to be excluded from the scope of the insurance contracts standard. In particular:

    (a) Some note that the proposals are not very clear about how a service provider would determine whether the primary purpose of a contract was insurance or the provision of services, particularly as some would consider the provision of insurance to be a service. Those with this view note that interpreting the 'primary purpose' will involve subjective judgement and may be difficult to apply consistently.

    (b) Some find unclear whether the term 'primary purpose' refers to the contract or to the issuer of the contract.

(c) Some find the reference to "providing goods or services to the policyholder to compensate for insured events" unhelpful because they believe the focus should be on the insured event, rather than on how the payment is made in the form of cash or in kind.

15. Although many criticised the requirements as unclear, few offered alternative suggestions. Those that were suggested included:

(a) Distinguishing between a contract requiring an entity to provide services whose amount might **vary** if there is an adverse event (which some suggested should be excluded from the scope) and a contract requiring an entity to provide service only **in the event of** an adverse event (which should be accounted for as an insurance contract).

(b) Distinguishing contracts based on whether the service or the insurance element of the contract is predominant and excluding from the scope those for which the service element is predominant.

(c) Distinguishing contracts based on the primary business of the issuer and excluding from the scope those for which the issuer's primary business is the provision of services.

(d) Treating fixed-fee service contracts in the same way as financial guarantee contracts, ie accounting for them as service contracts if the issuer previously accounted for them as service contracts.

### *Staff analysis and recommendation*

*Fixed fee service contracts*

16. Fixed-fee service contracts meet the definition of an insurance contract when the insurance risk transferred by the contract is significant. Examples include:

(a) A maintenance contract in which the service provider agrees to provide a basic level of service to maintain specified equipment and additionally to repair the equipment in the event of a malfunction.

(b) Roadside assistance contracts, in which a provider agrees to provide roadside assistance, sometimes including the costs of any related parts and labour, in exchange for a fixed fee.

(c) Capitation agreements in which a provider agrees to provide, in exchange for a fixed fee, a variable amount of defined medical services for a specified group of patients. For example, a provider might agree to provide all ambulance transfer services for a specified period.

17. The ED/DP proposed to exclude from the scope of the insurance contracts standard fixed fee service contracts if their primary purpose is the provision of services because:

(a) the existing practice of accounting for such contracts as revenue contracts provides relevant information for the users of financial statements for the entities that issue such contracts; and

(b) changing the existing basis for accounting for these contracts would impose costs and disruption for no significant benefit.

18. In addition, most fixed fee service contracts would be eligible for the modified approach if they were included in the scope of the insurance contracts standard. This would mean that the accounting would be similar, regardless of whether such contracts were to be accounted for in accordance with the standard for insurance contracts or for revenue recognition (assuming the final standard retains an approach reasonably consistent with the revenue recognition standard).

19. There are two issues raised in the comment letters:

(a) Some disagree with the proposed scope exclusion. Accordingly, paragraphs 20 to 23 consider whether the boards should confirm the scope exclusion in the final standard.

(b) Some find the proposed scope exclusion unclear. Accordingly, paragraphs 24 to 30 consider how to clarify what was intended by the boards.

*Whether to confirm a scope exception for fixed fee service contracts*

20. In the staff's view, excluding some fixed-fee service contracts from the scope of the insurance contracts standard has the following disadvantages:

    (a) It is an exception to the principle that the proposed standard applies to all contracts that meet the definition of insurance contracts.

    (b) It is difficult to draw the line between fixed-fee service contracts and insurance contracts, and between different types of fixed-fee service contracts.

    (c) It results in lack of comparability because different accounting models would apply to similar types of contracts.

21. However, it is important to note that the claim estimation and development periods of many fixed-fee service contracts are limited. Accordingly, fixed-fee service contracts would nearly always qualify for the modified approach for short-duration contracts. This means that there would not necessarily be material differences if these contracts are accounted for under the revenue standard rather than the insurance contracts standard.

22. Furthermore, the staff agrees with the boards' previous conclusion, supported in the comment letters, that changing the existing accounting for these contracts within a revenue model would impose costs and disruption for no significant benefit.

23. Therefore, giving consideration to the balance of cost and benefits the staff recommend that some fixed-fee service contracts should be excluded from the scope of the insurance contract standard and accounted for under the revenue recognition standard. Paragraphs 26 to 29 discuss how to define those contracts.

*Clarifying the scope exception*

24. In the staff's view, the ED and DP are clear that the scope exclusion for fixed-fee service contracts is based on whether the primary purpose of the *contract* is the provision of services. Paragraph 4(e) of the ED and paragraph 28(e) of the DP

refers to "fixed fee service contracts that have as *their* primary purpose" and paragraph B7 of the ED refers to "the primary purpose *of the contract*" (emphasis added). Accordingly, we think it is clear that the ED intended that the scope exclusion should be based on the contract, and not the issuer of the contract.

25. The staff agrees with respondents that it is difficult to determine whether the primary purpose of a contract is insurance or the provision of services, particularly as some would consider the provision of insurance to be a service. Furthermore, interpreting primary purpose will involve subjective judgement and may be difficult to apply consistently.

26. The staff has identified the following approaches:

    (a) confirm the proposed scope exclusion in the ED/DP, including possible clarification that the assessment of whether the primary purpose is the provision of services is performed at the *contract* level.

    (b) provide a scope exclusion based on whether an entity's business model leads it to perceive itself as a provider of non-insurance services or as a provider of insurance. Using this approach, entities that are primarily providers of insurance and that have applied insurance accounting in the past would continue to be in the scope of the insurance contracts standard. Entities that are primarily providers of the underlying services rather than providers of insurance and who have accounted for such contracts as services in accordance with relevant revenue recognition standards would have their contracts excluded from the scope of the insurance contracts standard.

    (c) Eliminate the reference to the 'primary purpose' of the contract and distinguish only between a contract that provides service to the policyholder only in the event of an uncertain event, and a contract that provides both (i) a basic level of service in all cases and (ii) the possibility of extra services in the case of an adverse uncertain event. For example:

(i) in the maintenance contract described in paragraph 16(a), the provider would expect to provide some services, even without malfunction. However, if the equipment malfunctioned, the provider would incur additional costs. Such contracts would be excluded from the scope of the insurance contracts standard.

(ii) in the roadside assistance contract described in paragraph 16(b), the provider would provide service only in the event of a breakdown. Such contracts would be included in the scope of the insurance contracts.

(iii) In a contract which combines a car maintenance programme with roadside assistance, the provider would always expect to provide services and would incur additional costs in the event of a breakdown. This would therefore be treated in the same way as the maintenance contract and be excluded from the scope of the insurance contracts standard.

27. In any of these approaches, the following applies:

(a) There is an arbitrary distinction between the service and revenue component. This will mean that any scope exclusion for fixed-fee service contracts will inevitably result in inconsistent treatment for very similar contracts.

(b) Assuming the boards retain accounting for pre-claims liabilities in the modified approach that is similar to the requirements for revenue recognition, there will be very similar accounting between contracts that are within the scope of the insurance contracts standard and those that are in the scope of the revenue recognition standard.

28. With this in mind, we list the following factors to consider for each of the three identified approaches as follows:

(a) *Confirming the approach in the ED:* The disadvantage of this approach is that some have criticised the clarity of the proposed scope exclusion, in particular the reference to the 'primary purpose' of the contract. However, this was a relatively small number of respondents, and most did not disagree. Although subjective, this approach would be based on a relatively clear principle: that contracts intended to provide service are service contracts and those intended to provide insurance are insurance contracts.

(b) *Scope exclusion based on entity's business model:* This approach has the advantage of being relatively clear because it is fairly easy to determine the primary purpose at an *entity* level. Furthermore, the approach would probably be workable, as a similar approach was followed for financial guarantee contracts (refer paper 2E). However, the disadvantage of this approach is that it undermines the principle that the insurance contracts standard should deal with the accounting for insurance contracts, and not for the entities that issue those contracts (Assumption 6(f) as discussed in agenda paper 3A of 17 February 2011). In addition, this approach may result in service contracts issued by insurance entities that are not considered insurance under current standards being accounted for as insurance.

(c) *Scope exclusion based on uncertain event:* This approach has the advantage that it does not rely on a subjective estimate of what a contract's 'primary purpose' is. It is consistent with the definition of an insurance contract in that it depends on the occurrence or non-occurrence of an uncertain event. However, any provision of service would result the contract being treated as a fixed fee service contract and thus outside the scope of the insurance contracts standard. In addition, this approach would prevent entities that provide both included and excluded services, perhaps to the same customers, from using a common accounting and reporting model for both.

29. In the staff's view, there is no clear winner. Each approach has difficulties. However, the staff recommend confirming the ED/DP (primary purpose based on the individual contract level) because the staff think that the relatively straightforward principle, and the requirement to assess the purpose of the contract, rather than assuming the purpose from the issuer's business model outweigh the relative merits of the others. Furthermore, this approach would place the focus on the predominant offering of the contracts, rather than on the basis of a specific (potentially insignificant) component as is the case under the uncertain event approach.

***Restricting the scope exclusion to contracts eligible for the modified approach***

30. As noted in paragraph 27(b), there will be very similar accounting between (a) contracts that are within the scope of the modified measurement approach within the insurance contracts standard and (b) fixed fee service contracts that would be within the scope of the revenue recognition standard. However, in the staff's view, this level of comparability with the results of applying the revenue recognition standard would not exist for contracts that are not within the scope of the modified measurement approach. Therefore, the staff recommends that there should be no scope exclusion for contracts that do not qualify for the modified measurement approach. The staff will ask the boards to discuss at a future meeting which contracts should be eligible for that approach.

| Scope – fixed fee service contracts |
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| Do the boards agree to narrow the scope exclusion proposed in the ED to exclude from the scope of the insurance contracts standard fixed-fee contracts that:<br><br>(a) have as their primary purpose the provision of services; and<br><br>(b) ~~do not~~ qualify for the modified approach for short-duration contracts? |

*Scope exclusions other than fixed fee service contracts*

31. There were no significant concerns raised by respondents on the scope exclusions listed in paragraph 3, other than fixed fee service contracts. Most comment letters did not comment on them and those that did supported them. Accordingly, we have not provided a detailed analysis and recommend that the boards confirm these scope exclusions.

| Question: scope exclusions other than fixed fee service contracts |
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| Do the boards confirm the following scope exclusions:<br>(a) product warranties issued by a manufacturer, dealer or retailer?<br><br>(b) employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans?<br><br>(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item?<br><br>(d) residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease?<br><br>(e) contingent consideration payable or receivable in a business combination?<br><br>(f) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder)? |

## Impact on other areas of the insurance contract project

32. The scope defines the contracts to which the insurance standard would apply.

33. The staff recommendation refers to the eligibility criteria for the modified approach for some short duration contracts.

34. There are no other significant interrelationships between decisions made on scope and other areas of the project.

**Appendix A – extracts from the Exposure Draft and the Discussion Paper**

## Scope

***Exposure Draft***

2. An entity shall apply this [draft] IFRS to:
   - (a) insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.
   - (b) financial instruments that it issues containing a discretionary participation feature (see paragraphs 62–66).

3 This [draft] IFRS does not address other aspects of accounting by insurers, such as accounting for their financial assets and financial liabilities, other than those mentioned in paragraph 2(b) (see IFRS 9 *Financial Instruments,* IFRS 7 *Financial Instruments: Disclosures,* IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*), except in the transition requirements in paragraph 102.

4 An entity shall not apply this [draft] IFRS to:
   - (c) product warranties issued by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).
   - (d) employers' assets and liabilities under employee benefit plans (see IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see IAS 26 *Accounting and Reporting by Retirement Benefit Plans*).
   - (e) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item (eg some licence fees, royalties, contingent lease payments and similar items, see IAS 17 Leases, IAS 18 and IAS 38 Intangible Assets).

(f) residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 and IAS 18).

(g) fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event, for example maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction (see IAS 18). However, an insurer shall apply this [draft] IFRS to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.

(h) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).

(i) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the *policyholder*). However, a *cedant* shall apply this [draft] IFRS to reinsurance contracts that it holds.

5 For ease of reference, this [draft] IFRS describes any entity that issues an insurance contract as an *insurer*, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.

6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to reinsurance contracts.

***Discussion Paper***

28 The following would be excluded from the scope of the proposed guidance:

(a) Product warranties issued by a manufacturer, dealer, or retailer. (See Topic 460, Guarantees.)

(b) Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans.

(c) Contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item (for example, some license fees, royalties, contingent lease payments, and similar items). (See Topic 840, Leases, and Topic 350, Intangibles—Goodwill and Other.)

(d) Residual value guarantees provided by a manufacturer, dealer, or retailer, as well as a lessee's residual value guarantee embedded in a finance lease. (See Topics 840 and 350.)

(e) Fixed-fee service contracts that have the provision of services as their primary purpose, but that expose the service provider to risk because the level of service depends on an uncertain event. However, an insurer would apply the proposed guidance to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.

(f) Contingent consideration payable or receivable in a business combination. (See Topic 805, Business Combinations.)

(g) Direct insurance contracts in which the entity is the policyholder. However, a cedant would apply the proposed guidance to reinsurance contracts that it holds.

## Appendix B – Application guidance

***Payments in kind***

B6 Some insurance contracts require or permit payments to be made in kind, in which case the insurer provides goods or services to the policyholder to settle its obligation to compensate the policyholder for insured events. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder for the amount of its loss. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the insurance contract.

B7 For some fixed-fee service contracts, the level of service depends on an uncertain event. Although such contracts meet the definition of an insurance contract if the uncertain event would cause significant additional payments by the insurer, they are outside the scope of this [draft] IFRS if the primary purpose of the contract is the provision of services. Examples of such contracts are:

> a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction.
>
> a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage.

## Appendix C – extracts from the Basis for Conclusions on Exposure Draft

### Fixed-fee service contracts (paragraph 4(e))

BC208 A fixed-fee service contract is a contract in which the level of service depends on an uncertain event. Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. Such contracts meet the definition of an insurance contract because:

(a) it is uncertain whether, or when, a repair or assistance is needed;

(b) the owner is adversely affected by the occurrence; and

(c) the service provider compensates the owner if a repair or assistance is needed.

BC209 The Board proposes to exclude fixed-fee service contracts from the scope of the proposed IFRS if their primary purpose is the provision of services. In the Board's view, the existing practice of accounting for such contracts as revenue contracts provides relevant information for the users of financial statements for the entities that issue such contracts and changing the existing accounting for these contracts would impose costs and disruption for no significant benefit.