IASB/FASB Meeting
4 May 2011

IASB Agenda reference 1

FASB Agenda reference 66

Staff Paper

Project: **Insurance contracts**

Topic: **Cover note**

What is this paper about?

1. This paper:

   (a) provides an overview of the papers for the meeting on 4 May, together with a summary of the staff recommendations for the papers (paragraphs 3 - 5).

   (b) summarises the progress the boards have made and describes what is still to come (paragraph 6).

   (c) reviews the sources of volatility remaining in the model (paragraphs 7 - 8).

   (d) describes next steps and provides a revised project timetable (paragraph 9 - 11).

2. The Appendix provides a detailed summary of previous decisions taken by the boards.

Overview of papers

Participating contracts

3. **Agenda paper 1A/66A *Participating features – Topic overview*** This paper is an introduction to a group of papers that discuss measurement of contracts containing

discretionary participation features. Those papers will be discussed at this and future meetings. Agenda paper 1A/66A provides background information on the nature of these contracts and an overview of the proposals in the ED. No decisions are requested in this paper.

4. **Agenda paper 1B/66B *Measurement of policyholder participation* -** This paper considers how to apply the principle that an insurance contract is measured using the expected present value of the fulfilment cash flows when those cash flows result from contractual participation features. In this paper, the staff recommends that:

(a) the fulfilment cash flows should include the cash flows expected to result from the policyholder participation on the same basis as the measurement of the underlying items the policyholder participates in. This could be assets and liabilities, the performance of underlying pool of insurance contracts or the performance of the entity.

(b) the measurement of the participating contract should reflect the asymmetric risk sharing between insurer and policyholder in the contractually linked items that exists because of the minimum guarantee.

(c) the presentation of the changes in the insurance contract liability in the statement of comprehensive income should be consistent with the presentation of the changes in the linked items (ie profit or loss, or in other comprehensive income)

(d) the same measurement approach should apply to unit-linked and participating contracts. Consequently the boards should not proceed with the proposals in the IASB's exposure draft (ED) for consequential amendments relating to the following items held in unit-linked funds: treasury shares and owner occupied property.

Unbundling

5. This session of papers discusses whether non-insurance components in an insurance contract should be separated using the principles being developed in the revenue recognition project.

   (a) **Agenda paper 1C/66C *Supporting material for unbundling*** provides supporting material for the papers on unbundling by setting out:

      (i) The project plan for the unbundling decisions

      (ii) Background, including:

         - the proposals on unbundling goods and services and investment components from insurance contracts; and

         - feedback received from comment letters, outreach and field tests on those proposals.

      (iii) Context for the boards' decisions on unbundling at this meeting.

   (b) **Agenda paper 1D/66D *Unbundling goods and services*** recommends that goods and services should be unbundled from an insurance contract in accordance with the principles on identifying separate performance obligations in the revenue recognition project. Once separated those goods and services would be measured in accordance with relevant requirements of IFRSs and US GAAP.

   (c) **Agenda paper 1E/66E *Unbundling investment component*** recommends, that:

      (i) explicit account balances in insurance contracts that meet specified criteria should be unbundled. The specified criteria are adapted from those being developed for identifying separate performance obligations in the revenue recognition project; and

      (ii) if the account balance meets the specified criteria, that component should be accounted for in accordance with the relevant requirements for financial instruments in IFRS/US GAAP.

Progress report

6. The following table summarises the progress the boards have made and describes what is still to come

Building block/Area	Topic	Tentative decisions	Open points
Building block 1 – Which cash flows?	Recognition point	• Recognise insurance contract assets and liabilities when the coverage period begins. • Onerous contract liability to be recognised in the pre-coverage period if management becomes aware of onerous contracts in the pre-coverage period.	• How to apply onerous contract test in pre-coverage period.
	Contract boundary	• Contract renewals should be treated as a new contract: (a) when the insurer is no longer required to provide coverage; or (b) when the existing contract does not confer any substantive rights on the policyholder. • A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. • In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio. • All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation.	

	Fulfilment cash flows – objective	Expected value, with guidance that: • expected value refers to the mean that considers all relevant information; and • not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the measurement objective of determining the mean.	
	Fulfilment cash flows – which cash flows	• Include all costs that the insurer will incur directly in fulfilling the contracts in that portfolio, ie: o costs that relate directly to the fulfilment of the contracts in the portfolio; o costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and o such other costs as are specifically chargeable to the policyholder under the terms of the contract. • Exclude costs that do not relate directly to the insurance contracts or contract activities, which should be recognised as expenses in the period in which they are incurred.	
	Acquisition costs	IASB: Include in fulfillment cash flows all the directly attributable costs that the insurer will incur in acquiring a portfolio of insurance contracts. FASB: Include in fulfillment cash flows: • those costs related to successful acquisition efforts; and • direct costs that are related to the acquisition of a portfolio of insurance contracts.	
Building block 2 – Time value of money	Discounting	• Objective is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability • Current rate that is updated each reporting period • Not required when the effect of discounting would be immaterial.	
	Discount rate	• No prescribed method to determining the discount rate, but rate	

		should: o be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk; o exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability (eg risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed to the policyholder); and o reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability. • To the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets (ie for participating contracts), the insurer should adjust those cash flows using a discount rate that reflects that dependence. In some cases, the insurer determine the yield curve for the insurance contract liability based on a yield curve that reflects current market returns for either the actual portfolio of assets the insurer holds, or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability. In doing so, the insurer excludes from those rates factors that are not relevant to the insurance contract liability (a 'top-down' approach). In a 'top down' approach: • An insurer shall determine an appropriate yield curve based on current market information. The insurer may base its determination of the yield curve for the insurance contract liability on a yield curve that reflects current market returns for the actual portfolio of assets the insurer holds or for a reference portfolio of assets with	

		characteristics similar to those of the insurance contract liability. • If there are no observable market prices for some points on that yield curve, the insurer shall use an estimate that is consistent with the boards' guidance on fair value measurement, in particular for Level 3 fair value measurement. • the cash flows of the instruments shall be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. In adjusting the cash flows, the insurer shall make both of the following adjustments: o Type I, which adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows. o Type II, which adjust for risks inherent in the assets that are not inherent in the liability. In the absence of an observable market risk premium for risks inherent in the asset but not inherent in the liability, the entity uses an appropriate technique to determine that market risk premium, consistent with (b). • an insurer using a 'top-down' approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in the asset cash flows.	
Building block 3 – Risk adjustment	Relevance of risk adjustment	If there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment in the measurement of those liabilities would provide relevant information to users.	• Whether to require an explicit risk adjustment
	Risk adjustment	Objective: The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected.	• Techniques • Disclosures • Level of aggregation (including diversification benefits)

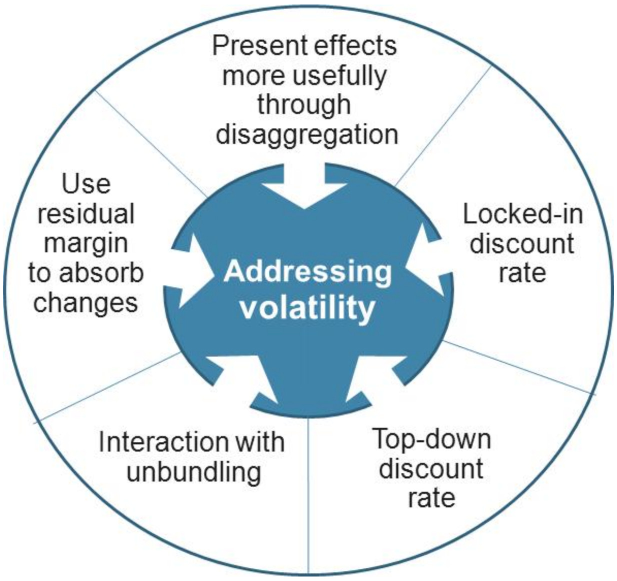
Building block 4 – Residual margin	Residual / composite margin	• No gain at inception of an insurance contract. • Any loss on day one recognised immediately when it occurs, in profit or loss (net income).	• Whether and how to unlock the residual or composite margin • Level of aggregation • Release of residual margin
Special applications	Participating features	• Objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating insurance contracts. • Provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependence.	• At this meeting we will consider the measurement of contracts with participating features
	Short duration contracts	• [IASB only]An insurer should deduct from the pre-claims obligation measurement the acquisition costs that the IASB would include in the measurement of the insurance contract liability under the building block approach. • The insurer shall reduce the measurement of the pre-claims obligations over the coverage period as follows: o On the basis of time, but o On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. • An insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.	• Objective of a modified approach • Criteria for eligibility for a modified approach • How to reflect the boards' tentative decision on reflecting the time value of money in the revenue recognition project in determining whether the pre-claims obligation should reflect the time value of money. • Whether the modified approach should be permitted or required • [FASB only: acquisition costs]

			• Presentation
	Reinsurance		• Gains on inception • Contract boundary/short duration interaction
Definition and scope and unbundling	Definition	• Confirm proposed definition in the ED and DP, together with the guidance that: (a) an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant. (b) a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss, with loss defined as an excess of the present value of net cash outflows over the present value of the premiums.	
	Scope	• Exclude from the scope of the insurance contracts standard some fixed–fee service contracts which have as their primary purpose the provision of services. • Confirm all the other scope exceptions proposed in the ED • IASB: Financial guarantee contracts (as defined in IFRSs) would not be in the scope of the insurance contracts standard as proposed in the ED. Instead: (a) an issuer of a financial guarantee contract (as defined in IFRSs) is permitted to account for the contract as an insurance contract if the issuer had previously asserted that it regards such contracts as insurance contracts; and (b) an issuer of a financial guarantee contract (as defined in IFRSs) is required in accordance with the financial instruments standards in all other cases.	• How to identify fixed-fee service contracts which have as their primary purpose the provision of services • Investment contracts with discretionary participation features • FASB: which financial guarantee arrangements, if any, should be within the scope of the insurance contracts standard.

	Unbundling	An insurer should account separately for embedded derivatives that are contained in a host insurance contract that is not closely related to the embedded derivative.	At this meeting we consider whether to unbundle: 1. Goods and services 2. Account balances and unit-linked contracts We will consider further unbundling issues at a future meeting, including contract riders, allocation of expenses to unbundled components and whether to permit unbundling where not required.
Presentation and disclosure	Presentation		• Whether and how to expand the summarised margin approach • Whether and how to disaggregate changes in the liability • Where (ie within profit and loss, or in other comprehensive income) any disaggregated components should be presented.
	Disclosures		• Address detailed issues raised
	Transition and effective date		• Consider how to approximate residual /composite margin on transition • Determine effective date

The volatility issue

7. We continue to monitor the effects of the boards' decisions on reported volatility. Although our objective is not to minimise volatility, we believe that the boards should consider, throughout their discussions, whether any reported volatility is a faithful representation of the underlying economic phenomena.



8. As shown in the diagram above, there are five areas that would have an impact upon the volatility as reported, and we describe below how the boards' tentative decisions to date and current indications would affect each of those areas:

   (a) *discount rate*. In February 2011, the boards confirmed that both a top-down and a bottom-up approach can achieve the objective of the discount rate and that the insurer can decide which approach is best in its circumstances. In April 2011, the boards clarified that, in a top-down approach, fluctuations in the overall asset spread, other than those arising from expected credit losses and the market risk premium for bearing credit risk, would be attributed to the illiquidity component of the asset yield and hence would also be mirrored in the changes in the liability discount rate. This could be a significant proportion of the changes in the overall spread on bonds. In the staff's view, this removes a portion of the volatility from the changes in bond yields, compared to ‘bottom-up’ approach that most interpreted the ED/DP to require.

(b) *locking in the discount rate at inception*. At its 1-2 March 2011 meeting, the boards tentatively confirmed that the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period (ie not to lock in the discount rate for any insurance contract).

(c) *presentation* eg by presenting the effects of volatility separately, or by defining a measure of ‘operating profit’ for insurers. We intend to ask the boards for decisions on this topic in a future meeting.

(d) *unlocking the residual margin.* We are considering whether and how to unlock the residual margin. As requested by the boards, we are investigating the similarities and differences in the Australian margin on services approach to an unlocked residual margin to assess the practical implications. We intend to bring the topic back for decision in June.

(e) *extensive unbundling*, with the investment components measured at amortised cost. We discuss unbundling in agenda papers 1C/66C, 1D/66D, 1E/66E.

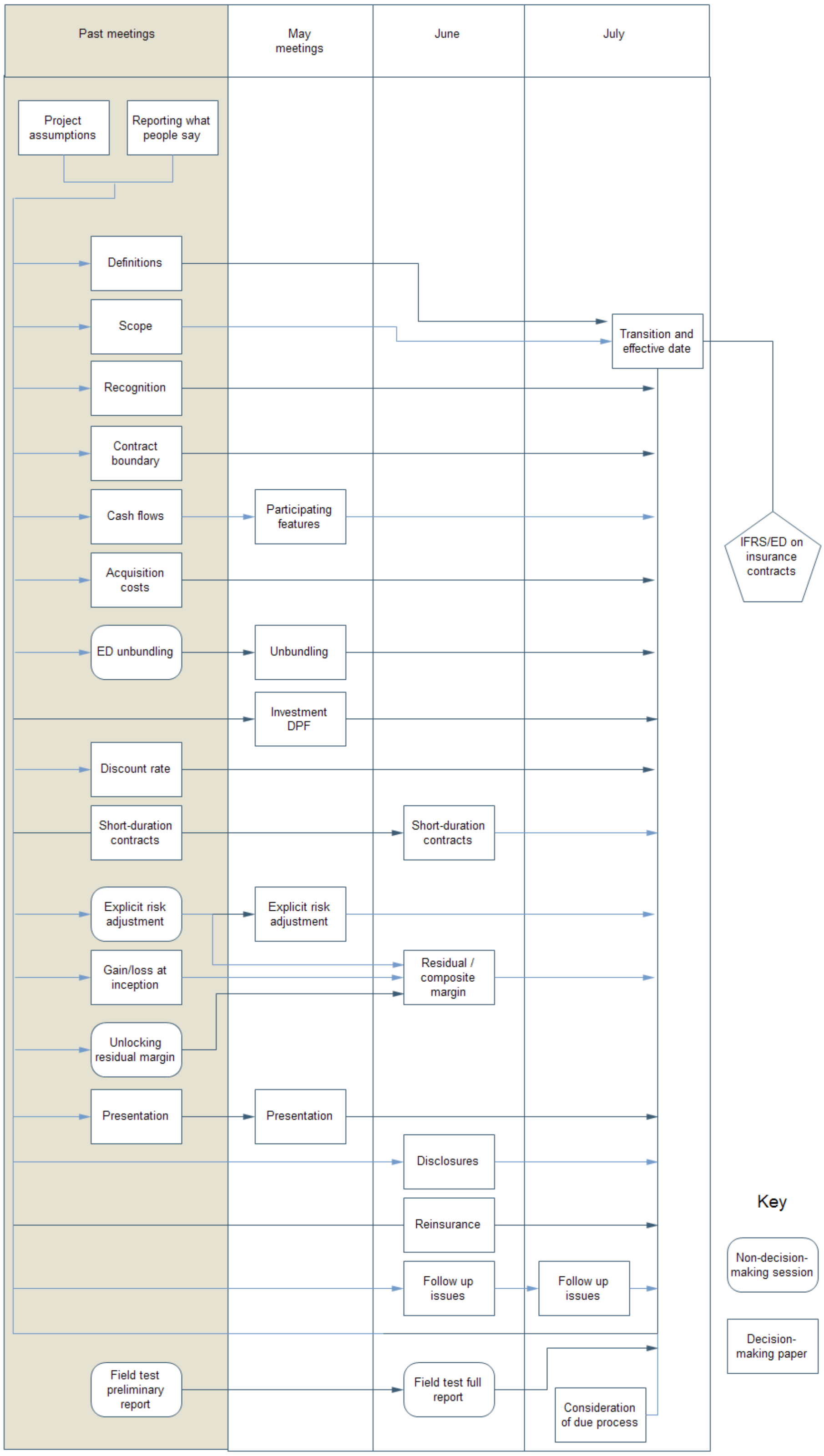
Next steps and proposed project timetable

9. On 21 April 2011, the IASB and FASB published a progress report on their joint work to improve International Financial Reporting Standards and US generally accepted accounting practices, and to bring about their convergence. This report stated the boards are aiming to complete their deliberations on the major issues by the end of June, but are unlikely to have completed all discussions until the second half of 2011. Once the boards have completed their deliberations, they will prepare their next due-process documents. For the FASB this will be an exposure draft and for the IASB this will be an IFRS. Before an insurance contracts standard is finalised the boards will follow the same procedures described in the progress report for the revenue recognition and leases projects,

including assessing whether the proposals should be re-exposed and making a draft widely available as the basis for performing additional outreach.

10. The IASB is working to issue a new IFRS by the end of 2011. The FASB will consider the feedback received on its exposure draft with a view to finalising a standard in 2012. The boards will then consider any differences that may have arisen and how best to address them.

11. We set out revised project plan on the following page.


Past meetings
May meetings
June
July
Project assumptions
Reporting what people say
Definitions
Scope
Recognition
Contract boundary
Cash flows
Acquisition costs
ED unbundling
Discount rate
Short-duration contracts
Explicit risk adjustment
Gain/loss at inception
Unlocking residual margin
Presentation
Field test preliminary report
Participating features
Unbundling
Investment DPF
Explicit risk adjustment
Presentation
Short-duration contracts
Residual / composite margin
Disclosures
Reinsurance
Follow up issues
Field test full report
Transition and effective date
Follow up issues
Consideration of due process
IFRS/ED on insurance contracts
Key
Non-decision-making session
Decision-making paper

Appendix: Summary of previous decisions taken by the boards

Project axioms and assumptions

A1. The boards tentatively confirmed the axioms and assumptions (listed below) that will underlie the development of the project's future direction. Those axioms and assumptions will provide a common understanding of the factors that will influence the staff in their analysis and will be a starting point for further decisions. (The observer notes for the February main meeting list some areas in which the staff plan specific follow-up work in some areas covered by the assumptions.) In addition, the IASB noted that the model would be developed on the assumption that the financial assets backing the insurance contracts would be measured in accordance with IFRS 9 *Financial Instruments*. The IASB has no current plans to change the classification and measurement requirements in IFRS 9.

Axioms

A2. An ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.

A3. An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.

A4. Money has a time value and an entity more faithfully represents its position when it measures its liabilities in a way that includes the time value of money.

Assumptions

A5. The boards will develop a standard for insurance contracts, rather than requiring current or proposed generic standards that might otherwise apply.

A6. The standard will deal with the accounting for insurance contracts from the perspective of the insurer, and not for the assets backing the contracts or for the entities that issue those contracts. For the IASB, the financial assets backing the contracts would be measured in accordance with IFRS 9.

A7. The boards will develop a standard based on an accounting model that regards insurance contracts as creating a bundle of rights and obligations that work together to generate a package of cash inflows and outflows.

A8. In general, the final standard will measure insurance contracts at the portfolio level.

A9. The accounting model should be based on current estimates, rather than carrying forward estimates made at contract inception and inputs that are consistent with observable market data, where available.

A10. The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfills the insurance contract.

A11. The model will use the expected value of future cash flows rather than a single, most likely outcome.

A12. The measurement of the liability will not reflect changes in the insurer's own credit standing.

Definition of an insurance contract

A13. The IASB’s exposure draft (ED) *Insurance Contracts* and the FASB’s Discussion Paper *Preliminary Views on Insurance Contracts* (DP) proposed to define an insurance contract as ‘a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder’. The boards tentatively decided to confirm the proposal in the ED and DP that:

a) an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant.

b) a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss, with loss defined as an excess of the present value of net cash outflows over the present value of the premiums.

Scope

A14. The boards tentatively confirmed the proposal in the ED/DP to exclude from the scope of the insurance contracts standard some fixed–fee service contracts which have as their primary purpose the provision of services. The boards will consider in a future meeting how to identify such contracts.

A15. The boards tentatively confirmed all the other scope exceptions that had been proposed by the ED/ DP.

A16. The IASB tentatively decided that financial guarantee contracts (as defined in IFRSs) would not be in the scope of the insurance contracts standard as proposed in the ED. Instead, the IASB tentatively decided to retain the existing approach in IFRSs that:

a) permits an issuer of a financial guarantee contract (as defined in IFRSs) to account for the contract as an insurance contract if the issuer had previously asserted that it regards the contract as an insurance contract; and

b) requires an issuer to account for an a financial guarantee contract (as defined in IFRSs) in accordance with the financial instruments standards in all other cases.

A17. The IASB also tentatively decided it would not create an exception from the accounting for financial guarantee contracts for intragroup guarantees.

A18. The FASB decided to consider at a future meeting which financial guarantee arrangements, if any, should be within the scope of the insurance contracts standard.

Recognition

A19. The boards tentatively decided that insurance contract assets and liabilities should initially be recognized when the coverage period begins, and to require the recognition of an onerous contract liability in the pre-coverage period if management becomes aware of onerous contracts in the pre-coverage period.

Contract boundary

A20. The boards tentatively decided that:

a) Contract renewals should be treated as a new contract:

i. when the insurer is no longer required to provide coverage; or

ii. when the existing contract does not confer any substantive rights on the policyholder.

b) A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

c) In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.

d) All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation.

Discount rate

Current vs locked- in

A21. The boards tentatively confirmed the proposal in the IASB's exposure draft *Insurance Contracts* (ED) and the FASB's discussion paper *Preliminary Views on*

Insurance Contracts (DP) that the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period (ie not to lock in the discount rate for any insurance contract).

For non-participating contracts

A22. The boards tentatively confirmed the approach in the IASB's exposure draft (ED) *Insurance Contracts* and the FASB's discussion paper (DP) *Preliminary Views on Insurance Contracts* that the objective of the discount rate is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability.

A23. The boards tentatively decided not to prescribe a method for determining the discount rate and that the discount rate should:

a) be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk;

b) exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability (eg risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed to the policyholder); and

c) reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

A24. The boards tentatively decided that in applying the top-down approach:

a) An insurer shall determine an appropriate yield curve based on current market information. The insurer may base its determination of the yield curve for the insurance contract liability on a yield curve that reflects current market returns for the actual portfolio of assets the insurer holds or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability.

b) If there are no observable market prices for some points on that yield curve, the insurer shall use an estimate that is consistent with the boards' guidance on fair value measurement, in particular for Level 3 fair value measurement.

c) the cash flows of the instruments shall be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. In adjusting the cash flows, the insurer shall make both of the following adjustments:

   i. Type I, which adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows.

   ii. Type II, which adjust for risks inherent in the assets that are not inherent in the liability. In the absence of an observable market risk premium for risks inherent in the asset but not inherent in the liability, the entity uses an appropriate technique to determine that market risk premium, consistent with (b).

d) an insurer using a 'top-down' approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in the asset cash flows.

For participating contracts

A25. The boards tentatively decided to:

   a) clarify that the objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating insurance contracts.

   b) provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependence.

For non-life contracts

A26. The boards tentatively agreed that discounting of insurance liabilities should not be required when the effect of discounting would be immaterial. The boards asked the staff to develop, as part of the papers on the modified approach, additional guidance for determining when discounting a contract with a short-tail claim would be considered immaterial.

A27. The boards tentatively decided to require discounting for all non-life long-tail claims.

For ultra-long duration contracts

A28. The boards discussed the effects of changes in discount rate where the yield curve is extended beyond observable market prices-so-called 'ultra long duration' contracts. The boards indicated that they did not want the staff to develop a separate approach that deals solely with changes in discount rate for this particular type of contract.

Cash flows

A29. In relation to **expected value**, the boards tentatively decided to clarify:

a) that the measurement objective of expected value refers to the mean that considers all relevant information; and

b) that not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the measurement objective of determining the mean.

A30. In relation to **costs included in fulfillment cash flows** the boards tentatively decided:

a) to clarify that all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to measure the insurance liability, including:

- costs that relate directly to the fulfilment of the contracts in the portfolio, such as payments to policyholders, claims handling, etc (described in paragraph B61 of the ED);
- costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and
- such other costs as are specifically chargeable to the policyholder under the terms of the contract.

b) to confirm that costs that do not relate directly to the insurance contracts or contract activities should be recognised as expenses in the period in which they are incurred;

c) to provide application guidance based on IAS 2 *Inventories* and IAS 11 *Construction Contracts*; and

d) to eliminate the term 'incremental' from the discussion of fulfilment cash flows that was proposed in the ED / DP (ie paragraph B61 of the ED).

A31. In relation to **acquisition costs**, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts. However:

a) The IASB tentatively decided that those acquisition costs should be all the costs that the insurer will incur in acquiring the portfolio, including costs that relate directly to the acquisition of the portfolio. The IASB directed the staff to draft application guidance on this topic for the boards' consideration.

b) The FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to

(i) those costs related to successful acquisition efforts; and

(ii) direct costs that are related to the acquisition of a portfolio of contracts.

c) The FASB directed the staff to develop implementation guidance on which direct costs related to the acquisition of a portfolio of contracts would be included in the cash flows of insurance contracts.

Explicit risk adjustment

A32. The boards tentatively decided that, if there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment in the measurement of those liabilities would provide relevant information to users.

A33. The boards tentatively decided:

- to remove references in the objective of the risk adjustment proposed in paragraph 35 of the ED to 'the amount the insurer would rationally pay to be relieved of the risk' and to a 'maximum amount'. As a result, the objective of the risk adjustment would be as follows:
  'The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected."
- to provide application guidance that this amount would reflect both favourable and unfavourable changes in the amount and timing of fulfilment cash flows.

The recognition of gain and loss at inception

A34. The boards tentatively confirmed the proposal in the ED and the DP that an insurer should:

a) not recognise any gain at inception of an insurance contract.

b) recognise any loss on day one immediately when it occurs, in profit or loss (net income).

Unbundling

A35. The boards confirmed the proposal in the ED and DP that an insurer should account separately for embedded derivatives that are contained in a host insurance contract that is not closely related to the embedded derivative.

Short duration contracts

A36. The boards discussed whether a different approach should be used for the accounting in the pre-claims period for contracts, typically short duration, that meet specified criteria. In particular, the boards discussed what those criteria might be and whether that different approach was a proxy for the building block approach or a separate model.

A37. The boards tentatively decided that:

(a) They would consider whether the pre-claims obligation should reflect the time value of money, based on their tentative decision on reflecting the time value of money in the revenue recognition project.

(b) The insurer shall reduce the measurement of the pre-claims obligations over the coverage period as follows:

a) On the basis of time, but

b) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

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

12. In addition, the IASB tentatively decided that an insurer should deduct from the pre-claims obligation measurement the acquisition costs that would be included in the measurement of the insurance contract liability under the building block approach. The FASB has yet to conclude on this issue.