STAFF PAPER

27 February – 2 March 2012

REG IASB | FASB Meeting

Project	**Insurance contracts**		
Paper topic	Onerous contracts		

CONTACT(S)	Izabela Ruta	iruta@ifrs.org	+44 (0) 20 7246 6957
	Rachel Knubley	rknubley@ifrs.org	+44 (0) 20 7246 6904

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB *Action Alert* or in IASB *Update*.

What is the paper about?

1. During the meeting on 12-16 December 2011, the boards tentatively decided that:

   (a) an insurance contract is onerous if the expected present value of the future cash outflows from that contract [plus the risk adjustment for the IASB, subject to decisions to be taken as a result of this paper] exceeds:

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

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

   (b) insurers should perform an onerous contract test when facts and circumstances indicate that the contract might be onerous. The boards also tentatively decided that they would provide application guidance about the facts and circumstances that could indicate a contract is onerous.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

(c) onerous contracts identified in the pre-coverage period should be measured on a basis consistent with the measurement of the liability recognised at the start of the coverage period. Similarly, onerous contracts identified under the premium allocation approach should be measured on a basis consistent with the measurement of the liability for claims incurred. The boards noted that these decisions require further consideration in view of the boards' tentative decision to introduce a practical expedient that would permit insurers not to discount claims incurred that are expected to be paid within 12 months of the insured event. This is discussed in agenda paper 3B/79B.

2. The purpose of this paper is to continue the discussion on onerous contracts. This paper asks:

   (a) both boards to consider when to re-measure an onerous contract liability (see paragraphs 7 - 8); and

   (b) the IASB to consider whether the risk adjustment should be considered when identifying onerous contracts, and whether the measurement of an onerous contract liability should include a risk adjustment (see paragraphs 9 - 20).

3. Paragraphs 7 - 20 are mainly reprinted from the agenda paper 7D/77D *Onerous contracts* for the meeting on 12 -16 December 2011.

4. Agenda paper 3C/79C discusses instances in which it becomes apparent shortly before the end of a reporting period that a catastrophe (eg a hurricane) may occur shortly after the end of the reporting period.

5. In addition, this paper does not discuss:

   (a) whether an onerous contract test is needed under the single margin approach.

   (b) the unit of account for the onerous contract test.

   These issues will be discussed at a future meeting.

Summary of staff recommendations

6. The staff recommend that:

   (a) the measurement of an identified onerous contract liability should be updated at the end of each reporting period.

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

Re-measurement of the liability for onerous contracts

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

8. Consequently, the staff recommend that the board should confirm the ED proposals that the measurement of the liability for onerous contracts that have been identified should be updated at the end of each reporting period.

Question to the boards

Question 1: Re-measurement of the liability for onerous contracts
Do you agree that the measurement of the liability for onerous contracts that have been identified should be updated at the end of each reporting period?

Measurement of the liability for onerous contracts – risk adjustment (IASB only)

9. The IASB has tentatively decided to include a risk adjustment in the measurement of the insurance contract liability. The risk adjustment is defined as the compensation an insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract.

10. The following sections discuss whether the risk adjustment should be considered when identifying and measuring onerous contracts.

Relevant comments received

11. Some respondents to the ED noted that including a risk adjustment in the onerous contract test could result in the recognition of losses for contracts that are ultimately profitable. These respondents view the risk adjustment as deferred profit that will be earned if the actual cash flows do not exceed those expected at contract inception. These respondents believe that determining a contract in a loss position based on the expected cash flow plus what some consider being a portion of expected profit that is at risk (risk adjustment or a single margin) would be unduly burdensome.

12. Many respondents suggested that the liability for remaining coverage should be more like the 'Unearned Premium Reserve' (UPR) which is used widely in practice. Some respondents therefore did not believe it was appropriate to include an explicit risk adjustment as part of the liability for onerous contracts under the premium allocation approach. Additionally, some respondents suggested that requiring the insurer to apply the full building block approach routinely to determine whether contracts were onerous would over-complicate the premium allocation approach.

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

Staff analysis

14. Agenda paper 8A for the board meeting during the week commencing 18 July 2011 (FASB memo 71A) discussed whether to exclude a risk adjustment from the measurement of a liability for onerous contracts under the premium allocation approach. The staff provided the following arguments in favour of excluding the risk adjustment from the onerous contract liability:

    (a) contracts would be identified as onerous less frequently.

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

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

    (d) in the Revenue project, the boards propose to exclude a risk adjustment when measuring the liability for onerous contracts. Consistency with the Revenue standard would reduce differences between the accounting treatments for insurance contracts and for contracts within the scope of Revenue standard—which may reduce the pressure on the scope of the two standards.

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

15. However, the staff note that:

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

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

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

(d) not requiring a risk adjustment might create a further difference between the building block approach and the premium allocation approach;

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

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

(g) the risk adjustment as characterised by the IASB is part of the measurement of the insurance liability rather than as deferred profit. Therefore some staff believes that excluding the risk adjustment from measurement of an onerous contract, based on understanding that it is a deferred profit, misrepresents the objective of risk adjustment.

16. The staff think that these arguments are applicable to the liability for onerous contracts in the pre-coverage period as well as for contracts measured using the premium allocation approach. For the reasons set out in paragraph 15, the staff recommend that the measurement of onerous contract liabilities should include a risk adjustment.

17. The staff have considered an approach whereby the risk adjustment is excluded when *identifying* onerous contracts, but included when *measuring* any contracts identified as onerous. In other words, the Board could decide that a contract would be treated as onerous only if the expected present value of the future cash outflows (excluding a risk adjustment) exceeds the expected present value of the future cash inflows. However, contracts that are *identified* as onerous would be *measured* using the full building block approach (including a risk adjustment).

18. Such an approach would address the concerns of some respondents that a loss could be recognised on a potentially profitable contract. These respondents noted that if actual experience is in line with expectations at the start of the contract, the risk adjustment will ultimately be recognised as profit. If, therefore, the risk adjustment is included in identifying onerous contracts a loss could be recognized on a potentially profitable contract simply because the cash flows may be uncertain prior to the coverage of the contract or prior to the occurrence of an insured event.

19. Others think that it would be inconsistent to exclude a risk adjustment when identifying onerous contracts but include it for measurement purposes. In addition, in situations where the risk adjustment is significant, this approach would result in onerous contracts not being recognised. Consequently, these staff recommend that the risk adjustment should be considered when identifying onerous contracts.

20. The staff acknowledge that including a risk adjustment when identifying onerous contracts will make the onerous contract test more difficult to apply. However, the staff note that the additional difficulty is reduced by the boards' previous decision that an insurer should perform an onerous contract test only when facts and circumstances indicate that the contract might be onerous.

Questions to the Board

Question 2: Measurement of the liability for onerous contracts
IASB only Do you confirm that: (a) the risk adjustment should be considered when identifying onerous contracts; (b) the measurement of the liability for onerous contracts should include a risk adjustment?