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STAFF PAPER

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REG FASB | IASB Meeting

Project	**Insurance contracts**		
Paper topic	Onerous contract – implications of tentative decisions		
CONTACT(S)	Izabela Ruta	iruta@ifrs.org	+44 (0) 20 7246 6957
	Rachel Knubley	rknubley@ifrs.org	+44 (0) 20 7246 6904
	Jennifer Weiner	jmweiner@fasb.org	+1 203 956 5305

What is the paper about?

1. This paper addresses an issue raised during the December Board meeting for contracts accounted for under the premium allocation approach. Board members noted that there might be unintended consequences arising from the interaction between the tentative decisions:
    a. that an insurance contract is onerous if the expected present value of the future cash outflow from the contract [plus for the IASB the risk adjustment] exceeds the carrying amount of the liability for remaining coverage;
    b. not to require discounting of the liability for incurred claims if the claims are expected to be paid within 12 months; and
    c. to measure onerous contracts on the same basis as the liability for incurred claims.
2. In particular, if an entity chooses not to discount the liability for incurred claims then (applying the tentative decisions made) an insurer would be required to:
    a. identify its onerous contracts on a discounted basis; and
    b. measure its onerous contracts on an undiscounted basis.
3. This paper does not discuss the unit of account that should be used when applying the onerous contract test. This will be discussed at a future meeting.

Staff recommendation

4. Some staff believe that, the tentative decisions already made by the boards about the identification and measurement of onerous contracts should apply whether an entity chooses to apply the practical expedient or not. Consequently, some staff recommend that if an insurer elects not to discount the liability for incurred claims which are expected to be paid within 12 months of the date of the incurred loss the insurer should:
    a. identify whether a contract is onerous on a discounted basis; and
    b. measure the liability for onerous contracts on an undiscounted basis (consistent with the current tentative decisions).
5. Other staff recommend that if an insurer elects not to discount the liability for incurred claims which are expected to be paid within 12 months of the date of the incurred loss, the insurer should:
    a. identify whether a contract is onerous on a discounted basis; and
    b. measure the liability for onerous contracts on a discounted basis (approach (b)).

Background

6. At the joint IASB and FASB meeting on 12-16 December 2011, the boards tentatively decided to provide a practical expedient for contracts accounted for using the premium allocation approach. This practical expedient would permit insurers not to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event.
7. During the same week the boards tentatively decided that for contracts accounted for under the premium allocation approach:
    a. An insurance contract is onerous if the expected present value of the future cash outflows from that contract [plus, for the IASB, the risk adjustment] exceeds the carrying amount of the liability for the remaining coverage.

   b. Onerous contracts identified under the premium allocation approach should be measured on a basis consistent with the measurement of the liability for incurred claims.

8. The boards noted that these decisions require further consideration for the situations where the practical expedient allowing insurers to record their liability for incurred claims on an undiscounted basis is applied because of possible unintended consequences.

Staff analysis

9. Applying the tentative decisions stated in paragraphs 6 - 7 an insurer that chooses the practical expedient not to discount the liability for incurred claims would:
   a. identify onerous contracts on a discounted basis; and
   b. measure onerous contracts on an undiscounted basis (consistent with its measurement of the liability for incurred claims).
10. This approach has the following advantages:
    a. An onerous contract liability is only recognised when the contract is considered onerous on a discounted basis.
    b. It does not create a measurement difference between the liability for onerous contracts and the liability for incurred claims as they are both measured on an undiscounted basis. If the insurer is measuring the future costs of fulfilling the contract on an undiscounted basis then it would be reasonable to record the onerous contract liability at that same measurement.
11. In addition, the staff note the following:
    a. According to the decision tentatively taken by the board at 12-16 December 2011 meeting, an insurer is required to test whether a contract is onerous only when facts and circumstances indicate that the contract might be onerous. Consequently, discounting of projected cash flows would only be required when facts and circumstances indicate that the contract might be onerous.
    b. In practice, if facts and circumstances indicate that a contract might be onerous, an insurer would be likely to:

i. First determine whether a contract is onerous on an undiscounted basis. For example, a specific line of business may have a combined loss ratio (incurred claims divided by premiums earned) of 101% determined on an undiscounted basis.

ii. If a contract appears to be onerous on an undiscounted basis then an insurer would perform a high level analysis to determine whether the contract would be onerous on a discounted basis. For example, if an insurer expects that the claims would be discounted by 4% it is unlikely that facts and circumstances would indicate that the contract is onerous unless the loss ratio was greater than 104% (assuming all claims are paid one year after they are incurred).

iii. Only if the contract appears to be onerous on a discounted basis would the insurer go on to prepare cash flow projections on a discounted basis.

12. However, this approach results in onerous contracts being identified and measured on an inconsistent basis.

13. In addition, the staff note that the practical expedient not to discount the liability for incurred claims is restricted to situations where the claim is expected to be settled within 12 months (presumably on the basis that the effect of discounting is unlikely to be significant in such a short period of time). However, an insurer may identify a contract as onerous during the coverage period. Consequently, the period of time between when a contract is identified as onerous and the expected settlement of the claim could be greater than 12 months. For example, a portfolio of contracts with a coverage period of 3 years could be identified as onerous 6 months into the coverage period. If the claims are expected to be incurred at the end of the coverage period, and settled 12 months later, the effect of discounting during the 42 months before payment would be ignored. This means that the effect of discounting on the onerous contract liability recognised could be significant.

14. The staff have considered the following alternative ways of identifying and measuring onerous contracts when an entity chooses not to discount the liability for incurred claims (these are presented in the table below):

    a. identify onerous contracts on an undiscounted basis;

b. require discounting for both identification and measurement purposes;

c. identify and measure onerous contracts on a discounted basis and require discounting of the liability for incurred claims if a contract is identified as onerous.

Table 1: Considered approaches

	Identification of onerous contracts	Measurement of onerous contract liability	Measurement of claims liability
Applying tentative decisions	Discounted cash flows	Undiscounted cash flows	Undiscounted cash flows
(a)	Undiscounted cash flows	Undiscounted cash flows	Undiscounted cash flows
(b)	Discounted cash flows	Discounted cash flows	Undiscounted cash flows
(c)	Discounted cash flows	Discounted cash flows	Discounted cash flows

(a) Identifying and measuring onerous contracts on an undiscounted basis

15. Identifying and measuring onerous contracts on an undiscounted basis would ensure that onerous contracts were identified and measured on a consistent basis. However, the staff note that in many jurisdictions, insurers consider investment income or the effects of discounting when testing whether a contract is onerous.

16. In addition, this approach, would have the following consequences[1]:

    a. onerous contracts would be identified more quickly and more often than on a discounted basis. If discounting is not considered in the analysis, a significant number of the contracts that would qualify for the practical

[1] If an insurer chooses to discount the liability for incurred claims (i.e. the insurer chooses not to adopt the practical expedient) no such problems arise.

expedient not to discount the liability for incurred claims would be identified as onerous;

b. an onerous contract liability and its associated expenses might be recognised in situations when the contract is not onerous on a discounted basis. This could result in insurers recognizing onerous contracts when the insurance contract is written;

c. requiring insurers to identify onerous contracts on an undiscounted basis if they apply the practical expedient may result in them choosing not to apply the practical expedient

17. Consequently, the staff do not recommend this approach.

(b) Discounting for both identification and measurement purposes

18. Under this approach, an insurer would test for the existence of onerous contracts on a discounted basis and also measure any resulting liability on a discounted basis. Because in most situations the insurer will need to discount the cash flows in order to identify onerous contracts, some staff believe that measuring the resulting liability on a discounted basis will not require significant additional effort. However, other staff believe that measuring a liability on an undiscounted basis requires more effort than simply identifying whether the contract is onerous on a discounted basis.

19. The advantages of this approach are as follows:

    a. An onerous contract liability would only be recognised when the contract is considered onerous on a discounted basis;

    b. The effects of discounting, if material, would be considered when measuring the onerous contract liability.

20. The disadvantages of this approach are as follows:

    a. A measurement difference arises when the onerous contract liability is superseded by the liability for incurred claims (the onerous contract liability is measured on a discounted basis but the liability for incurred claims would be measured on an undiscounted basis). Because the onerous contract liability would be less than the liability for incurred claims (measured on an undiscounted basis) a loss would arise on recognition of the liability for incurred claims. Some staff question whether recognizing a loss at that point simply because the liability for incurred claims is measured on a different basis to the onerous contract liability provides the users of the financial statements with useful information about the events of the current period. In addition, the reason for this loss is difficult to explain to users as it is recognised when the onerous contract liability is superseded by the liability for incurred claims rather than when the entity determines the contract is onerous.

b. Requiring an insurer to both identify and measure onerous contracts on a discounted basis arguably undermines the simplifications introduced by the practical expedient not to discount the liability for incurred claims.

21. Staff note that the effects of discounting will decrease over time. Consequently, the discount may no longer be significant when the onerous contract liability is superseded by claims which are expected to be settled within less than 12 months.

(c) Require discounting of the liability for incurred claims if a contract is identified as onerous

22. Under this approach an insurer would be required to use discounted cash flows for testing whether a contract is onerous. If based on this calculation the contract is determined to be onerous, the insurer would be required to book the onerous contract liability on a discounted basis. To avoid the difference identified in paragraph 20a, the insurer would be required to book its liability for incurred claims on a discounted basis as well.

23. Advantages of this solutions are as follows:

    a. An onerous contract liability would only be recognised when the contract is considered onerous on a discounted basis.

    b. The effects of discounting, if material, would be considered when measuring the onerous contract liability.

    c. No measurement difference arises when the onerous contract liability is superseded by the liability for incurred claims.

24. The disadvantages of this solution are as follows:

a. incurred claims will be measured on an inconsistent basis[2] (i.e. incurred claims arising from contracts that have previously been assessed to be onerous would be measured on a discounted basis whilst others would be measured on an undiscounted basis). This introduces additional complexity into the model. Insurers do not track incurred claims based upon whether they were previously identified as onerous at the moment. They would need to modify their systems and convert their data to identify the claims that would need to be discounted and determine the appropriate discount rate. Although this decision would impact only those claims expected to be outstanding for 12 months or less, the costs to implement could outweigh the benefits.

b. it ignores the reasons why the boards tentatively decided to provide a practical expedient not to discount claims expected to be paid within 12 months from when incurred.

Summary and staff recommendation

25. Each of the approaches discussed has some advantages and disadvantages; staff has prepared a summary of characteristics of each solution in the table below.

[2] The staff acknowledge that the introduction of an optional practical expedient already results in some inconsistency in the measurement of the liability for incurred claims. However, approach (c) would result in inconsistent measurement depending upon whether a contract had previously been identified as onerous.

Table 2: Summary of proposed solutions and related issues

Issues	Proposed approaches: Current tentative decisions (discounting for identification; no discounting for measurement)	(a) No discounting for identification or measurement	(b) discounting for both identification and measurement purposes	(c) Require discounting of the liability for incurred claims if contract identified as onerous
Discounting used in identifying onerous contract?	Yes	No	Yes	Yes
Onerous contract measured on discounted basis?	No	No	Yes	Yes
Same measurement for liability for onerous contracts and incurred claims	Yes	Yes	No	Yes
The same measurement for all liabilities for incurred claims	Yes	Yes	Yes	No

26. As noted in paragraph 17, the staff do not support requiring entities to identify onerous contracts on an undiscounted basis (approach (a)) as this would result in onerous contracts being identified more quickly and more often than on a discounted basis and when the contracts are potentially not onerous.
27. The staff also do not support approach (c) (requiring discounting of the liability for incurred claims if a contract is identified as onerous). Under approach (c) there is inconsistent measurement of the liability for incurred claims for contracts which are identified as onerous and those which are not. The staff believe that this ignores the reasons for the boards tentative decisions to allow a practical expedient and would not provide useful information to users of financial statements.

28. Some staff support applying the same guidance for all contracts regardless of whether the liability for incurred claims is recorded on a discounted or undiscounted basis. This means requiring insurers that choose the practical expedient to identify claims on a discounted basis and measure them on an undiscounted basis (consistent with the current tentative decisions). An onerous contract is usually understood to mean a contract in which the future costs of fulfilling the contract are expected to exceed the future benefits expected to arise from that contract. At the December joint board meeting, the boards tentatively decided not to require discounting of the liability for incurred claims if they are expected to be paid within 12 months from the occurrence date. Some believe that recognizing an onerous contract liability essentially accelerates the recognition of the liability for incurred claims. Consequently, some staff believe that the measurement of an onerous contract liability, should be consistent with the measurement of the liability for incurred claims (i.e. if the liability for incurred claims is on an undiscounted basis, the onerous contract liability should also be measured on an undiscounted basis.).
29. Some staff are concerned that the period of time between when a contract is identified as onerous and the expected settlement of the claim could be greater than 12 months. This means that the effect of discounting on onerous contracts could be more significant than the effect on claims liabilities that are expected to be settled in 12 months or less. Consequently, these staff believe that onerous contracts should be identified and measured on a discounted basis (approach (b)).
30. These staff acknowledge that under approach (b) a measurement difference, occurs when the onerous contract liability is superseded by the liability for incurred claims. However, as noted in paragraph 21 the measurement difference arising under approach (b) may not be significant. Any difference will be recognised in the statement of comprehensive income and (if significant would be visible to users).

Questions to the Boards

1. Do the Boards agree that if an insurer elects not to discount the liability for incurred claims which are expected to be paid within 12 months of the date of the incurred loss, the insurer should:

   Recommendation 1

a. identify whether a contract is onerous on a discounted basis; and

b. measure the liability for onerous contracts on an undiscounted basis (consistent with the current tentative decisions).

   Or

   Recommendation 2

c. identify whether a contract is onerous on a discounted basis; and

d. measure the liability for onerous contracts on an discounted basis (approach (b)).

2. If the Boards do not agree with the recommended solution, do the Board support any other solution?