STAFF PAPER

19–23 May 2014

REG IASB Meeting

Project	**Insurance Contracts**
Paper topic	Non-targeted issues—fixed-fee service contracts, significant insurance risk, portfolio transfers and business combinations

CONTACT(S)	Barbara Jaworek	bjaworek@ifrs.org	+44 (0)20 7246 6452
	Joanna Yeoh	jyeoh@ifrs.org	+44 (0)20 7246 6481

Objective

1. During its meeting in April 2014, the IASB discussed the project plan for the issues raised in the comment letters that were outside the five areas that were targeted for input in the IASB's 2013 Exposure Draft *Insurance Contracts* (the 2013 ED).[1] At that meeting, the IASB agreed to discuss further seven of these issues.

2. Among these issues, the IASB asked the staff to analyse further the issues relating to:
   (a) fixed-fee service contracts;
   (b) significant insurance risk guidance; and
   (c) contracts acquired through a portfolio transfer or a business combination.

3. The objective of this Agenda Paper is to provide further analysis of the issues listed in paragraph 2 and to recommend to the IASB the way of addressing these issues.

Staff recommendation

4. The staff recommend that the IASB:

[1] See Agenda Paper 2C *Project plan for the non-targeted issues* that is available at: http://www.ifrs.org/Meetings/Pages/IASB-Apr-14.aspx.

(a) that entities should be permitted, but not required, to apply the revenue recognition Standard to the fixed fee service contracts that meet the criteria stated in paragraph 7(e) of the 2013 ED (see paragraphs 5–13);

(b) clarify the guidance in paragraph B19 of the 2013 ED that significant insurance risk occurs only when there is a possibility that an issuer incurs a loss on a present value basis (see paragraphs 14–21); and

(c) amend the requirements for the contracts acquired through a portfolio transfer or a business combination in paragraphs 43–45 of the 2013 ED, to clarify that such contracts should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or the business combination (see paragraphs 22–27).

Staff analysis

Fixed-fee service contracts (paragraph 7(e) of the 2013 ED)

Background

5. Fixed-fee service contracts are contracts under which a service provider agrees to compensate a customer by providing services following an uncertain event that adversely affects the customer, in exchange for a fixed-fee. Examples of such contracts include road-side 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 as defined in the 2013 ED.

6. However, the IASB decided to exclude fixed-fee service contracts from the scope of the proposed *Insurance Contracts* Standard (the Standard) in paragraph 7(e) of the 2013 ED as follows:

> An entity shall not apply this [draft] Standard to:
>
> …
>
> (e) fixed-fee service contracts that have, as their primary purpose, the provision of services and that meet all of the following conditions:
>
> (i) the entity does not reflect an assessment of the risk that is associated with an individual customer in setting the price of the contract with that customer;

(ii) the contract compensates customers by providing a service, rather than by making cash payments; and

(iii) the *insurance risk* that is transferred by the contract arises primarily from the customer's use of services.

An entity shall apply [draft] IFRS X *Revenue from Contracts with Customers* to such contracts.

…

7. The IASB made this decision because fixed-fee service contracts in various jurisdictions are typically accounted for using revenue recognition guidance. In the IASB's view this existing practice of accounting for such contracts as revenue contracts provides relevant information for the users of financial statements and changing the existing accounting for these contracts would impose costs and disruption for no significant benefit (see paragraph BC209 of the 2010 Exposure Draft *Insurance Contracts* (the 2010 ED)).[2] In other words, the IASB believed that the more complex insurance contracts proposals would impose costs and disruption that wold not be justified given that the application of those proposals would not provide significantly different information than that obtained by applying the revenue recognition model to these contracts.

Feedback received

8. A few respondents commented that some entities issue insurance contracts that provide both insurance coverage and the provision of fixed-fee services. An example is a motor insurance policy that provides both:

(a) coverage of damage and physical injury arising from accidents, and

(b) a roadside assistance.

9. In such cases, some existing accounting requirements would treat the entire contract as an insurance contract, and an entity would account for the cost of the service provided under the fixed-fee service component as part of the cost of the claims. In order to keep their existing practice, these respondents suggested that an option

[2] See also Agenda Paper 2D *Insurance Contracts: Scope* from March 2011 that is available at: http://www.ifrs.org/Meetings/Pages/IASB-FASB-2-March-2011.aspx and Agenda Paper 4A *Insurance Contracts: Scope: Fixed Fee Contracts* from October 2011 that is available at: http://www.ifrs.org/Meetings/Pages/IASB-FASB-Meeting-October-2011.aspx.

should be permitted to enable them to apply the proposed Standard to fixed-fee service contracts that meet the definition of an insurance contract.

Staff analysis

10. A fixed-fee service contract meets the definition of an insurance contract and, in the absence of the scope exclusion described in paragraph 6, it would be within the scope of the Standard. However, as stated in paragraph 6, the IASB has excluded fixed-fee service contracts from the scope of the proposed Standard as a practical expedient, in order to avoid the costs for an entity of changing the existing accounting for these contracts, given that applying insurance contracts accounting to such contracts would not provide sufficiently superior information to justify the costs of doing so. That reasoning would not be valid for entities that do treat fixed-fee service arrangements as part of insurance contracts. For such entities, the scope exclusion would be more difficult to apply than the general principle that an entity should apply the Standard to contracts that meet the definition of an insurance contract. Consequently, a requirement that such entities must change their existing practice of treating such contracts would mean that those entities would incur costs that the IASB intended to prevent by providing the scope exclusion.

11. To address this problem, the staff recommend that entities should be permitted, but not required, to apply the revenue recognition Standard to the fixed-fee service contracts that meet the criteria stated in paragraph 7(e) of the 2013 ED. This will reduce the cost and complexity of applying the new Standard by allowing the entities to apply the Standard that will be least costly for them to apply.

12. Some may be concerned with providing an option because such an option may impair comparability. However, the staff note that such contracts are likely to qualify for the premium allocation approach under the insurance contract proposals, and that the application of the insurance contracts proposals to such contracts would not result in materially different accounting outcomes than applying the revenue recognition requirements. This is because both models are based on a model that allocates consideration in the pattern of the transfer of service. However, there are differing costs to the entities applying either the revenue recognition or insurance contracts requirements based on their reporting systems, and in the disclosures provided.

Consequently, the staff believe that this option would have limited effect on comparability.

13. As an alternative approach, the staff analysed whether the existing criteria of the scope exclusion in paragraph 7(e) of the 2013 ED could be revised to address this issue. However, the fixed-fee service contracts for which the respondents would like an option have no particular identifying features except that they have been previously treated under insurance contracts accounting requirements rather than the revenue recognition accounting requirements.

Question 1: Fixed-fee service contracts
(a) Does the IASB agree to address the issue identified in paragraphs 8–9?
(b) If so, does the IASB agree that entities should be permitted, but not required, to apply the revenue recognition Standard to the fixed fee service contracts that meet the criteria stated in paragraph 7(e) of the 2013 ED?

Significant insurance risk guidance (paragraph B19 of the 2013 ED)

Background

14. The proposed definition of an insurance contract in the 2013 ED is the same as the existing definition in IFRS 4 *Insurance Contracts*:

> A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

15. However, paragraph B25 of the 2010 ED and paragraph B19 of the 2013 ED include additional application guidance, which states:

> In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.

16. Some of the respondents of the 2010 ED opposed the additional guidance (see paragraph 15), because they argued that the existing requirements of IFRS 4 for the definition of an insurance contract worked well, are well understood and have not generated any problems in practice.

17. Paragraph BC191(c) of the 2010 ED noted that the IASB had no specific reason to think that the absence of such guidance in IFRS 4 has led to misleading classification of contracts, but that the inclusion of such a test is consistent with its understanding of practice under US GAAP. Although IFRS 4 does not contain an additional test referring to the possibility of a loss, as provided by paragraph B19 of the 2013 ED, some entities applying IFRS have used this test to determine whether to use deposit accounting (ie financial instruments accounting) for contracts that meet the definition of an insurance contract (for example, some quota share reinsurance, multiple-year retrospectively-rated reinsurance and excess of loss contracts with long tail pay outs). This is because IFRS 4 permits entities to continue with most aspects of their previous accounting for insurance contracts and, for some entities applying IFRS 4, their previous accounting was US GAAP. The IASB decided to add the additional guidance that was mentioned in paragraph 15 to the 2010 ED and retained it in the 2013 ED so that, after the Standard is implemented, those entities applying US GAAP could continue to use a financial instruments model, rather than the insurance contracts model, for contracts that do not meet the test that was included in paragraph B19 of the 2013 ED.[3]

Feedback received

18. A few respondents are concerned that a literal interpretation of the wording of paragraph B19 of the 2013 ED would lead to a reclassification of a number of contracts that are widely accepted as containing significant insurance risk under the existing IFRS 4. For example, they question if the following would be considered an insurance contract according to paragraph B19 of the 2013 ED:

> A contract in which the premiums received from the policyholder is invested in a fund and the value of the fund can decrease. On death, the beneficiaries either (a) receive the value of invested fund or (b) if the invested fund is lower than original premiums, the issuer will 'top up' the amounts so that the beneficiaries receive the total of all premiums paid.

[3] See Agenda Paper 3D *Definition of an insurance contract* from March 2011 that is available at: http://www.ifrs.org/Meetings/Pages/IASB-FASB-March-2011.aspx.

Staff analysis

19. The staff think that the specific minimum death benefit contract described in paragraph 18 has significant insurance risk, because the entity could suffer significant losses on a present value basis on the amount paid on death when compared to the fees charged for the death benefit for a comparable stand-alone insurance contract without the deposit. In addition, the staff think that, in substance, the contract identified is economically similar to other contracts with minimum death benefits that would continue to be treated as insurance contracts. However, the staff agree that the contract would not be considered an insurance contract according to paragraph B19 of the 2013 ED.

20. The staff believe that the contract described in paragraph 18 should meet the definition of an insurance contract. Consequently, the staff recommend to clarify the wording in paragraph B19 of the 2013 ED by including the following changes (deleted text is struck through and new text is underlined):

> In addition, a contract ~~does not~~ transfer<u>s</u> insurance risk <u>only</u> if there is ~~no~~ <u>a</u> scenario that has commercial substance in which the ~~present value of the net cash outflows that is paid by the issuer can exceed the present value of the premiums~~ <u>issuer has a possibility of a loss on a present value basis</u>.

21. As an alternative, the staff suggest removing the guidance in paragraph B19 of the 2013 ED in its entirety. However, that would mean changing the existing practice so that contracts described in paragraph 18 would no longer be able to use the financial instrument model, but would account for the contracts as insurance contracts. The IASB's intention when adding the guidance to the 2010 ED and retaining it in the 2013 ED was to preserve the current classification for these contracts.

Question 2: Significant insurance risk guidance

(a) Does the IASB agree to address the issue identified in paragraph 18?

(b) If so, does the IASB agree to clarify the guidance in paragraph B19 of the 2013 ED that significant insurance risk occurs only when there is a possibility that an issuer incurs a loss on a present value basis, as proposed in paragraph 20?

Contracts acquired through a portfolio transfer or a business combination (paragraphs 43–46 of the 2013 ED)

Background

22. Paragraph 46 of the 2013 ED states that all the requirements of the 2013 ED apply to insurance contracts acquired through a portfolio transfer or a business combination. In addition, paragraphs 43–45 of the 2013 ED include specific requirements regarding accounting for such contracts.

Feedback received

23. A few respondents sought clarification on whether they should account for the contractual service margin (CSM) when a contract has been acquired through a portfolio transfer or a business combination after the coverage period has ended, and the contract is in the settlement period. They think that the requirements are unclear as to whether an insurance contract in its settlement period should be treated as:

    (a) the remainder of a pre-existing contract that is in its post-coverage period (in this case no CSM would be recognised); or

    (b) a new insurance contract that is at the beginning of its coverage period (in this case the CSM would be set up in accordance with the general requirements proposed in the 2013 ED).

Staff analysis

24. In the staff's view, paragraphs 43–44 of the 2013 ED were intended to require that the contract acquired through a portfolio transfer or a business combination should be recognised from the date of the portfolio transfer or the business combination as a new contract. The CSM, if any, should be established using the difference in the fair

value of the contract (as a proxy of the premiums paid) and the expected value of the fulfilment cash flows.[4]

25. In effect, when an entity acquires a contract in its settlement period as a result of a portfolio transfer or a business combination, the entity has written a new contract in which the insured event is the discovery of a loss or the adverse development of claims for past events. The insured event is not the event giving rise to the claims in the first place.

26. Consequently, when an entity acquires the contracts through a portfolio transfer or a business combination:

    (a) a CSM arises when the fair value of the contract at the date of the portfolio transfer or the business combination is higher than the fulfilment cash flows at that date. The entity should recognise the CSM for the new service that will be provided, assess the coverage period and subsequently recognise the CSM in profit or loss as for any other new contracts. This is stated in paragraph 46 of the 2013 ED.

    (b) in the case when the fair value of the contract at the date of the portfolio transfer or the business combination is lower than the fulfilment cash flows, the contracts would be valued at the amount of fulfilment cash flows. The difference between the fulfilment cash flows and the fair value would either be recognised in goodwill, for the contracts acquired through a business combination, or as a day one loss, for the contracts acquired through a portfolio transfer.

27. Because the current wording is not clear and may cause difference in the interpretation and application, the staff propose to amend paragraphs 43–44 of the 2013 ED as follows (deleted text is struck through and new text is underlined):

    43 <u>When an entity acquires insurance contracts and reinsurance contracts in a portfolio transfer or a business combination, the entity shall recognise such contracts as if it had entered into the contract on the</u> ~~The~~ date of the portfolio transfer or business combination ~~is deemed to be the date of recognition for insurance contracts and~~

[4] See Agenda Paper 2E *Transition for contracts acquired through a business combination* from February 2013 that is available at: http://www.ifrs.org/Meetings/Pages/IASBFebruary2013.aspx.

~~reinsurance contracts that are acquired in a portfolio transfer or a business combination~~.

44 Unless paragraphs 35–40 [relating to the premium allocation approach] apply, an entity shall determine the contractual service margin, if any, for a contract acquired in a portfolio transfer or a business combination using ~~The entity shall treat~~ the consideration received or paid for the ~~a~~ contract ~~acquired in a portfolio transfer or business combination~~ as a ~~pre-coverage cash flow~~ proxy of the premiums received. If paragraphs 35–40 apply, an entity shall determine the liability for the remaining coverage using the consideration received or paid for the contract as a proxy for the premiums received.

44A The consideration received or paid for the contract excludes the consideration received or paid for any other assets and liabilities that were acquired in the same transaction. In a business combination, the consideration received or paid is the fair value of the contract at that date. That fair value reflects the portion of the total consideration for the business combination relating to the liability assumed.

45 The initial measurement of contracts acquired in a portfolio transfer or a business combination shall be ~~used when determining any goodwill or gain from a bargain purchase in accordance with IFRS 3~~ determined at:

(a) the fair value of the contract at the date of the portfolio transfer or the business combination, when the fair value is higher than the fulfilment cash flows. The difference between the fair value and the fulfilment cash flows shall be recognised as the contractual service margin; or

(b) the fulfilment cash flows, when the fair value of the contract at the date of the portfolio transfer or the business combination is lower than the fulfilment cash flows.

45A In a portfolio transfer, any excess of the fulfilment cash flows over the fair value of the contract at the date of the portfolio transfer shall be recognised as a loss at the date of the portfolio transfer.

Question 3: Contracts acquired through a portfolio transfer or a business combination

(a) Does the IASB agree to address the issue identified in paragraph 23?

(b) If so, does the IASB agree to amend the requirements for the contracts acquired through a portfolio transfer or a business combination in paragraphs 43–45 of the 2013 ED, to clarify that such contracts should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or the business combination, as proposed in paragraph 27?

Next steps

28. Agenda Paper 2C for this meeting discusses the allocation pattern for the CSM. Other non-targeted issues that were identified during the April 2014 meeting as needing further analysis will be presented to the IASB in separate Agenda Papers in future meetings. These issues are:

    (a) portfolio definition and unit of account;

    (b) discount rate for long-term contracts and unobservable market data; and

    (c) asymmetrical treatment of reinsurance contracts.