

Chapter 2

Overall Approach, Recognition and Derecognition

A Single Recognition and Measurement Approach for All Forms of Insurance

Principle 2.1

2.1 *There should be a single recognition and measurement approach for all forms of insurance contracts, regardless of the type of risk underwritten.*

2.2 The Issues Paper proposed that the accounting models for general insurance and life insurance should be separate, but based on the same underlying principles. The Issues Paper proposed that insurance should be treated, for financial reporting purposes, as:

- (a) general insurance if the insurer is committed to a pricing structure for not more than twelve months; and
- (b) life insurance if the insurer is committed to a pricing structure for more than twelve months.

2.3 Many respondents preferred a distinction based on the nature of the risk insured, rather than on the length of the insurer's price commitment. Some respondents argued that a distinction might be needed for performance reporting, segment reporting and other disclosure purposes, but that no distinction was needed for recognition and measurement purposes. The Steering Committee concluded that it is not helpful to distinguish between general insurance and life insurance for recognition and measurement purposes, as:

- (a) it is important that the same principles should be used for both general insurance and life insurance to ensure comparability; and
- (b) the differences between general insurance and life insurance are more a matter of degree than of principle. As a result, it is not always clear whether a particular type of contract should be classified as life insurance or general insurance. Indeed, different jurisdictions draw the boundary between general insurance and life insurance in different places. This may make it difficult to make the distinction in a consistent way.

2.4 An insurance contract creates contractual obligations and contractual rights. Accounting for those contractual obligations and contractual rights involves three stages:

- (a) recognising the resulting liabilities and assets (see principle 2.2);

- (b) measuring those recognised assets and liabilities (see chapters 3 to 6); and
- (c) derecognising previously recognised assets and liabilities that no longer exist (principle 2.3).

Recognition

Principle 2.2

2.5 ***Insurance assets and insurance liabilities are assets and liabilities arising under an insurance contract. An insurer or policyholder should recognise:***

- (a) ***an insurance asset when, and only when, it has contractual rights under an insurance contract that result in an asset; and***
- (b) ***an insurance liability when, and only when, it has contractual obligations under an insurance contract that result in a liability.***

2.6 The following paragraphs discuss two broad types of approach to accounting for insurance contracts, described in the Issues Paper as a deferral and matching approach and an asset and liability measurement approach.

Deferral and Matching Approach

2.7 The objective of a deferral and matching approach is to associate claim costs, which are generally unknown and hard to estimate, with premium revenue, which is more readily measurable. Accordingly, the revenue and expenses from an insurance contract are recognised progressively over time as services are provided. This generally leads to some or all of the following:

- (a) for short-term contracts (for example, many general insurance contracts) premiums are deferred and recognised as revenue over the term of the contract. If the deferred premium is insufficient to cover expected claims costs, an additional provision for premium deficiency is recognised;
- (b) for longer-term contracts, premium is recognised as revenue when it is received. The liability is measured on a basis that results in the recognition of net income from the contract (and, possibly, related investments) over the life of the contract on some basis that is intended to be systematic and rational. Various bases exist for allocating the net income to individual periods;
- (c) acquisition costs are deferred and amortised in order to match those costs with related premium revenue over the term of the contract; and
- (d) to portray pooling of risks over time, catastrophe and equalisation provisions are sometimes used for certain types of insurance.

2.8 Those who favour the deferral and matching approach argue that:

- (a) it is consistent with the diversification of risks, both between different contracts and over time, which is inherent in an insurance activity. The deferral and matching approach reports profit from insurance in a stable pattern reflecting that diversification and is, thus, relevant to users of an insurer's financial statements;
- (b) insurance contracts are primarily contracts to provide continuing services throughout the contract and settlement period, rather than financial instruments.¹ The deferral and matching approach is consistent with the percentage-of-completion method used for construction contracts in IAS 11, Construction Contracts, and long-term service contracts in IAS 18, Revenue. It is also consistent with the basis commonly used by investment managers for reporting management fees as revenue when those fees are earned;
- (c) the deferral and matching approach minimises the risk of imprudence and manipulation of reported profit, because it does not rely significantly on subjective estimates made at the inception of an insurance contract;
- (d) as insurance is a long-term activity, short-term fluctuations in market prices or in expectations of results from individual contracts are not relevant to users of financial statements;
- (e) the deferral and matching approach is largely consistent with a cost-based (entry-value) measurement of insurance liabilities. Existing International Accounting Standards require or permit cost-based measurements of various assets and liabilities, including property, plant and equipment and most financial liabilities; and
- (f) it is not practicable to implement an asset and liability measurement approach that is reliable and can be applied consistently based on the guidance in the Issues Paper.

Asset and Liability Measurement Approach

2.9 This DSOP proposes an asset and liability measurement approach that:

- (a) requires the recognition of insurance assets and insurance liabilities that meet the Framework's definitions, and recognition criteria for, assets and liabilities;
- (b) defines income and expenses in terms of changes in measurement of insurance assets and insurance liabilities; and
- (c) prohibits the recognition as assets or liabilities of items that do not meet those definitions or recognition criteria. Examples of such items currently found in insurers' financial statements in many countries are:

¹ Some who view the provision of insurance coverage as a service argue that this feature is particularly apparent when there is some legal or regulatory requirement to buy insurance (for example, in the case of compulsory motor insurance, employer's liability or professional indemnity).

- (i) deferred acquisition costs;²
- (ii) deferred premium revenue that differs from a realistic assessment of the insurer's remaining exposure to claims and risks under the contract;³
- (iii) catastrophe provisions for possible future claims under future contracts that will cover infrequent but severe catastrophes, such as earthquakes; and
- (iv) equalisation provisions to cover random fluctuations of claim expenses around the expected value of claims.

2.10 This DSOP proposes an asset and liability measurement approach, because:

- (a) the deferral and matching approach may result in the recognition of items in the balance sheet that do not meet the Framework's definition of assets and liabilities. As discussed in paragraph 1.40, insurance has special features. However, these special features are not sufficient to justify a departure from the Framework. By restricting the recognition of assets and liabilities to items that meet the definitions in the Framework, insurers will report financial information that better meets the needs of users. Users often complain that current insurance accounting is an impenetrable "black box". The asset and liability measurement approach will provide greater transparency and produce estimates of insurance assets and insurance liabilities that are more understandable;
- (b) although many insurance contracts require more significant administrative and servicing effort from the insurer than many traded financial instruments, the accounting model for financial instruments provides more relevant information for users than traditional deferral and matching models that are sometimes used for service revenue; and
- (c) the asset and liability measurement approach enhances the ability of users to make comparisons, as it forms the basis for other IASC standards.

2.11 Table 2.1 (see separate file) compares the deferral and matching approach and the asset and liability measurement approach. To some extent, a deferral and matching approach may lead to recognition of the same liabilities and assets as an asset and liability measurement approach. Similarly, it is a feature of both approaches that the insurer recognises income as it is released from risk, though the implementation of that feature differs between the two approaches. However, in some cases a deferral and matching approach may result in the recognition of items that are not liabilities or assets under the Framework.

² Costs are not in themselves an asset. However, some argue that some or all acquisition costs could be regarded as the cost of something that is, potentially at least, an asset. Principle 4.12 discusses acquisition costs.

³ Deferred premium revenue could be regarded as a cost-based (entry value) measurement of an insurance liability. Principle 3.1 discusses, among other things, the distinction between entry values and exit value.

- 2.12 Many respondents to the Issues Paper supported a deferral and matching approach, while many others supported an asset and liability measurement approach.
- 2.13 In the light of the arguments presented above, some members of the Steering Committee consider that the IASB should adopt a deferral and matching approach. However, as the majority of the Steering Committee are persuaded by the arguments for an asset and liability measurement approach, this DSOP adopts such an approach.
- 2.14 Although this DSOP does not propose the deferral and matching approach, principle 13.4 discusses, among other things, whether the IASB should require an insurer to report accruals-basis information of the kind that a deferral and matching approach would typically generate.

Recognition Criteria

- 2.15 The IASC Framework sets three criteria for the recognition of an asset or liability:
- (a) it should be probable that any future economic benefit associated with the item will flow to (or from) the enterprise;
 - (b) the item should have a cost or value that can be measured with reliability; and
 - (c) the item should meet the definition of an asset (or liability).

Probable Future Economic Benefit

- 2.16 Paragraph 3.2 of the Basis for Conclusions published with the JWG Draft states the following.

3.2 In accounting, the probability that an economic benefit will flow to (or from) the reporting enterprise has traditionally been considered to be a factor in determining whether an asset (or a liability) should be recognised. The recognition process seems to use the notion in two rather different ways.

- (a) Sometimes probability has been used to establish a recognition hurdle based on the likelihood of there being a future flow of economic benefits. The belief seems to have been that an asset or liability should not be recognised if there is only a low probability that conditions will occur that will result in a future inflow or outflow of economic benefits. However, the Draft Standard is reasoned from a premise that is well recognised and accepted in finance theory and in capital markets pricing practices. This premise is that the likelihood of there being a future flow of economic benefits arising from the financial instrument, and the probable amount of those future inflows or outflows, is a matter entering into the measurement of its fair value, not a matter affecting whether it should be recognised.

- (b) Sometimes probability has been used to determine whether, if there is to be a future flow of economic benefits associated with an item, it is likely that those benefits will flow to or from the enterprise. However, that is not an issue in the case of financial instruments because the contract establishing a financial instrument determines that any economic benefits that result from the instrument will flow to or from the enterprise.

- 2.17 The recognition criteria for provisions in IAS 37 include a probability hurdle of the kind discussed in the the JWG draft. Applied on a contract-by-contract basis, this criterion would prevent the recognition of almost all insurance contracts, as a payment on the individual contract would not be probable. However, if this criterion were applied to an entire book of contracts, many books (though perhaps not all) would pass this test. This distinction is similar to the existing distinction for financial guarantees measured under IAS 37 (see paragraph 1.61).
- 2.18 Consistent with the JWG Draft (and with the existing recognition criteria for financial instruments in IAS 39), and for the same reasons, this DSOP proposes that there should be no probability hurdle for the recognition of insurance contracts. The likelihood of a future flow of economic benefits arising from the insurance contract is a matter entering into its measurement (under the expected present value approach discussed in principle 4.1), not a matter affecting whether it should be recognised.

Reliability

- 2.19 The reliability of measurement for insurance contracts is discussed in principle 5.7. To summarise, this DSOP reflects the view that it will be possible to measure all insurance assets and all insurance liabilities with sufficient reliability for them to be recognised.

Meeting the Definition of an Asset (or Liability)

- 2.20 Therefore, the factor that determines when an insurance asset or insurance liability should be recognised is whether the item involved has the essential characteristics of an asset or liability. For that reason, and consistent with the JWG Draft, the proposed recognition and derecognition principles focus on the definitions of assets and liabilities in paragraph 49 of the Framework:
- (a) an asset is a “resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise”; and
- (b) a liability is a “present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits”.
- 2.21 An insurance contract specifies the contractual rights and contractual obligations that give rise to insurance assets and insurance liabilities. The event that creates insurance assets and insurance liabilities is becoming a party to the insurance contract. This

gives the insurer and the policyholder control over their contractual rights and creates contractual obligations that allow them little, if any, discretion to avoid the net cash outflows resulting from their contractual obligations.

- 2.22 The recognition criteria in principle 2.1 refer to the existence of contractual rights and contractual obligations. As discussed in paragraph 4.21, if such contractual rights and obligations exist, their measurement reflects:
- (a) legal rights and obligations arising from the explicit terms of the insurance contract;
 - (b) legal rights and obligations arising from the explicit terms of the insurance contract in conjunction with legislative, regulatory or other legal requirements; and
 - (c) constructive obligations flowing from the contractual obligations in (a) or (b). However, if no contractual rights or contractual obligations exist, a constructive obligation is not an insurance liability. IAS 37, Provisions, Contingent Liabilities and Contingent Assets, deals with the recognition and measurement of constructive obligations.
- 2.23 This DSOP takes the view that the contractual rights and contractual obligations under a book of insurance contracts form components of a single net asset or liability, rather than separate assets and liabilities. Principle 13.2 addresses separate disclosure of those components.
- 2.24 Under principle 2.2, insurance assets and insurance liabilities are defined and recognised on an individual contract-by-contract basis. The recognition principle, including the definitions of insurance assets and insurance liabilities, is used throughout this DSOP. However, the measurement of recognised insurance assets and insurance liabilities is based on books of insurance contracts (see principle 5.5).

Closed Book

- 2.25 Some propose an open book approach that accounts for both existing and future contracts. They argue that an open book approach is consistent with the fact that insurance is a long-term activity. In their view, many insurance contracts that have the form of one-year contracts are, in substance, similar to multi-year contracts because many such contracts are renewed more or less automatically and a failure to renew such a contract is, in substance similar to a lapse of a multi-year contract.
- 2.26 An open book approach is inconsistent with the Framework's definitions of assets and liabilities, which require the existence, as a result of past events, of a resource or present obligation. Principle 2.2 results in a closed book approach that accounts only for the contracts in force at the reporting date.
- 2.27 Future cash flows that may arise from possible future insurance contracts do not arise directly from the closed book. Under IAS 38, Intangible Assets, it is highly unlikely that they would give rise to a recognisable asset.

Renewals

- 2.28 To apply principle 2.2, it is necessary to determine whether possible future renewals of an existing contract are part of the existing contract or separate, future contracts. Principle 4.2. deals with this issue.

Derecognition

Principle 2.3

- 2.29 *An insurer or policyholder should derecognise an insurance asset or insurance liability or a component of an insurance asset or insurance liability when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that insurance asset, insurance liability or component.*

- 2.30 The JWG Draft's paragraph 26 defines the following terms that can be applied usefully to insurance contracts:

“Derecognition of an asset or liability or component thereof is ceasing to recognise that asset, liability or component on an enterprise's balance sheet.”

“The components of a financial instrument are the contractual rights to future economic benefits and the contractual obligations to transfer economic benefits that make up the financial instrument.”

- 2.31 Paragraphs 37-48, 224-231 and 3.1-3.30 of the JWG Draft deal with derecognition of financial instruments. There is no conceptual reason to apply different principles to insurance asset and insurance liabilities. However, principle 2.4 is a greatly simplified version of the JWG's proposals for derecognition as the JWG Draft deals with highly complex derecognition issues that are less likely to be relevant for insurance contracts.
- 2.32 Principle 1.6 prohibits unbundling of an insurance contract that bundles together an insurance element and a non-derivative investment element. Principle 2.3 requires derecognition of a component of an insurance asset or insurance liability when the insurer no longer has the related contractual rights or the contractual obligations. These two requirements are not inconsistent: principle 1.6 deals with accounting for elements that still exist, whereas principle 2.3 addresses components that no longer exist.
- 2.33 Most reinsurance contracts do not extinguish the cedant's contractual obligations under the direct insurance contract. It follows that most reinsurance contracts do not result in derecognition of the cedant's direct insurance liability.