

Chapter 9

Measurement of Direct Insurance Contracts by Policyholders

- 9.1 Principles 2.1-2.3 determine when insurance liabilities and insurance assets should be recognised. They apply just as much to policyholders as to insurers. Principle 9.1 considers whether it would be appropriate for policyholders to apply simpler measurement requirements to direct insurance contracts.

Principle 9.1

- 9.2 *A policyholder should apply principles 3.1 – 7.6 in measuring its contractual rights and obligations under a direct insurance contract.*

- 9.3 A **direct insurance contract** is an insurance contract that is not a reinsurance contract. For the following reasons, some propose simplified measurement requirements for a policyholder's contractual rights and obligations under a direct insurance contract:

- (a) a policyholder is unlikely to have as much information, or as much insurance measurement expertise, as the insurer. Therefore, most policyholders will not be able to make reliable measurements of their rights under insurance contracts;
 - (b) even if reliable measurements were possible, rights under insurance contracts are not a significant asset for most policyholders. The costs of measuring their rights at entity-specific value or fair value would be prohibitive and out of proportion to benefits for users;
 - (c) although fair value should be the same for both parties to an insurance contract, this is not necessarily true for entity-specific value. Entity-specific value, as described in this DSOP, may be regarded as the estimated market value of future entity-specific cash flows. The cash flows for the insurer include some cash flows (for example, claims handling costs or recoveries from salvage and subrogation) that will not occur for the policyholder; and
 - (d) on inception, the value attributed by a rational policyholder to the coverage acquired should not be less than the premium paid, which may differ from entity-specific value or fair value in some cases.
- 9.4 Proponents of this view suggest that the most practical approach is for the policyholder to measure pre-paid insurance on an amortised cost basis, with an additional amount to reflect any readily identifiable and material investment component.

- 9.5 For the following reasons, principle 9.1 proposes that the policyholder should measure its rights under a direct insurance contract on the same basis that the insurer uses for measuring its insurance liability:
- (a) the main focus of this project is on insurance contracts, rather than on insurers. Therefore, policyholder accounting should, conceptually, be consistent with insurer accounting; and
 - (b) fair value should be the same for both parties to the transaction, subject perhaps to the fact that policyholders do not have access to wholesale markets.
- 9.6 In many cases, a policyholder's contractual rights and obligations under direct insurance contracts will not be material to the policyholder's financial statements. In such cases, an acceptable approximation will often be to measure those contract rights and obligations as follows:
- (a) pre-paid insurance premiums at amortised cost. The amortised cost of a direct insurance contract is the amount of premiums paid, minus cumulative amortisation, and minus any write-down (directly or through the use of an allowance account) for impairment or uncollectability. Amortisation would be determined on a straight-line basis, unless another basis is more representative of the time pattern of the risks covered by the contract;
 - (b) any readily identifiable investment component at fair value;
 - (c) virtually certain reimbursements of expenditure required to settle a recognised provision at the present value of the reimbursement, but not more than the amount of the recognised provision (consistent with paragraph 53 of IAS 37, Provisions, Contingent Liabilities and Contingent Assets); and
 - (d) valid claims for an insured event that has already occurred at the present value of the expected future receipts under the claim. If it is not virtually certain that the insurer will accept the claim, the claim is a contingent asset and should, under IAS 37, not be recognised as an asset.
- 9.7 Some consider that there are particular circumstances when a policyholder should not recognise gains under an insurance contract. Consider, for example, a policyholder that enters into an insurance contract that gives it cover against liability claims. Under this DSOP, the policyholder's rights under the contract would be recognised as an asset, and those rights would be measured on a basis that includes the expected present value of future payments from the insurer to the policyholder. However, the policyholder would not normally (under IAS 37, Provisions, Contingent Liabilities and Contingent Assets) recognise a liability until it has a present obligation. Some consider it unreasonable that a policyholder should recognise its contractual rights to compensation (even on an expected value basis) at a time when it has not yet recognised an underlying obligation that would give rise to the compensation.
- 9.8 This DSOP takes the view that it is appropriate for the policyholder to recognise its contractual rights as an asset, even if the related obligation has not yet come into

existence. All other things being equal, an entity that holds such contractual rights is in a more favourable financial position than another entity that does not hold such contractual rights. The financial statements of the two entities should reflect that difference in their financial positions.

- 9.9 In the example discussed in paragraphs 9.7 and 9.8, some may find it helpful to view the policyholder's rights under the insurance contract as an option. If the insured event has not yet occurred, that option is out-of-the-money. An option that is a financial asset and falls within the scope of IAS 39 qualifies for recognition as an asset, even if the option is out of the money. The same principle applies to a policyholder's rights under an insurance contract.