

General Insurance

Basic Issue 7 What Assumptions and Conventions should be used in Accounting for General Insurance Contracts?

274. Basic Issue 7 builds on the discussion in Basic Issues 5 and 6. It deals with the following issues that are important mainly in a general insurance context:

- (a) should alternatives to the annual basis of accounting be prohibited, permitted, or required (Sub-issue 7A);
- (b) when should an insurer recognise liabilities and assets under a general insurance contract? In particular, how should an insurer recognise:
 - (i) **claims payable** - liabilities for insured events that have already occurred, including claims that have been **incurred but not reported (IBNR)**, claims that have been reported but not paid, and related **claim handling** expenses (including claim adjustment and claim processing expenses) (Sub-issue 7B);
 - (ii) liabilities for insured events that may occur during the remaining term of existing insurance contracts. Some argue that such liabilities should be reported as **unearned premiums** (augmented, where considered necessary, by a **provision for premium deficiency**). Others argue that they should be reported as a provision for **unexpired risks** (Sub-issue 7C);
 - (iii) **acquisition costs** (Sub-issues 7D and 7E);
 - (v) recoveries from **salvage** and **subrogation** (Sub-issue 7F); and
 - (vi) adjustments that arise in **retrospectively-rated contracts** (Sub-issue 7G);
- (c) should provisions for **equalisation** or **catastrophe (cat provisions)** be required, permitted, or prohibited (Sub-issue 7H);
- (d) to what extent should an insurer's liabilities be measured using present value (discounting) techniques (Sub-issue 7I)? If present value techniques are used, what discount rate is appropriate (Sub-issue 7J)?

The general insurance cycle and several accounting models for general insurance are examined in greater detail in Appendix A in the accompanying booklet.

Sub-issue 7A Should Alternatives to the Annual Basis of Accounting be Prohibited, Permitted or Required?

275. Any system of recognition and measurement principles must account for insurance activities that remain incomplete at the date of the financial statements. There would be little need for special consideration of insurance if all premiums were collected on the first day of the year and all claims were paid by the last day. However, the term of most contracts crosses the end of an accounting period. The time from the end of contract's term to the payment of the last claim may span several years, and until the last claim is paid, the insurer's total cost is unknown.
276. To deal with the problem described in the preceding paragraph, different jurisdictions have developed recognition models that vary considerably in the way they recognise and describe the assets, liabilities, revenue, and expenses that arise from general insurance activities. The discussion that follows illustrates how general insurance models reflect the receipt of an insurance premium, changes during the contract's term, and payment of claims and benefits.
277. Illustrations A1-A4 in the accompanying booklet of illustrations provide examples of three classes of accounting models for general insurance activities. Readers who are not familiar with the workings of these models may wish to study the illustrations as they read the discussion that follows.
278. **Periodic** models are also referred to as **deferred premium** models or the **annual basis**. (Refer to Illustration A1 in the accompanying booklet for an example of the periodic model.) Periodic models are used widely by general insurance enterprises to account for short-duration insurance contracts. Premiums are recorded as a liability and amortised to revenue over the contract's term. Claims are recorded as liabilities when the insured event occurs and charged to expense. Some observe that periodic models are similar in many ways with the accounting for rendering of services discussed in paragraphs 22-30 of IAS 18, Revenue.
279. **Open-year** models are also referred to as **fund** models or **deferred** models. (Refer to Illustration A3 for an example of the open-year model.) Open-year models recognise amounts based on the period in which contracts are issued, rather than over the period for which the insurer assumes risk. In some situations, premium revenue and claims expense are reported at a predetermined time (for example, three years) after the end of the underwriting year. In other situations, amounts are recognised as soon as premiums, claims, and expenses can be reliably measured. Amounts are reported in the balance sheet as a liability until information is available, at which time the amounts of revenue and expense and related profit are reported in the income statement. If evidence suggests that claims and expenses will exceed premiums (and the fund is deficient), the loss is recognised immediately. Today, the open-year model is used in limited situations when information about earned premiums, claims, and claim handling expenses is unavailable. It is also used by a few specialised entities like syndicates of Lloyd's of London.
280. **Zero-balance** models are sometimes described as models that use the **cost recovery basis**. (Refer to Illustration A4 for an example of the zero-balance model.) The zero-

balance model is similar to the open-year model, in that each is designed to report an underwriting profit of zero in the current period. However, the zero-balance model accomplishes this objective by increasing claim costs in the current period and adjusting claim costs in some future period.

281. Periodic models are more consistent than the open-year models and zero-balance models with financial reporting in most other industries. Most would probably agree that a periodic model should be used in most cases. The paragraphs that follow discuss whether open-year models or zero-balance models should be used in special cases where information about premiums, claims, and claim handling expenses is extremely limited.
282. IAS 18, Revenue, excludes insurance activities from its scope. However, the guidance in that Standard may be useful in analysing open-year models and zero-balance models. Paragraph 22 describes the conditions for recognising revenue from service activities:

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the balance sheet date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- (a) the amount of revenue can be measured reliably;
- (b) it is probable that the economic benefits associated with the transaction will flow to the enterprise;
- (c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and
- (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

283. Paragraphs 28-30 of IAS 18 describe the approach to be followed when the conditions in paragraph 22 are not satisfied:

28. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognised only to the extent of the expenses recognised that are recoverable.

29. During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

30. When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognised in accordance with paragraph 22 rather than in accordance with paragraph 28.

284. The approach described in those paragraphs is consistent with the zero-balance model. Unlike the open-year model, the approach outlined in IAS 18 reports revenue and expenses in the income statement during the period of uncertainty, but does not report any profit from the activity. In some jurisdictions, insurers use this approach when information about earned premiums, claims, and claim handling expenses is unavailable.

Views In Favour of the Zero-Balance Model

285. Some argue that insurance enterprises should not be allowed to use the open-year model. The zero-balance approach in IAS 18 is well established and understood by users of financial statements and the situations that insurers sometimes face are similar to those sometimes encountered in other commercial activities. Financial reporting is best served when similar situations receive the same accounting.

Views in Favour of the Open-Year Model

286. Others maintain that insurance enterprises should be required to use the open-year model in certain limited situations. Paragraph 22 of IAS 18 provides useful guidance on the conditions in which the open-year model should be used. However, they maintain that the cost-recovery or zero-balance approaches mandated by paragraphs 28-30 produce a misleading picture that suggests an enterprise operating at zero profit and may distort key ratios used by financial analysts. From this perspective, the open-year model provides a workable solution to a sometimes unavoidable problem. Accounting guidance in the United States and proposed guidance in the United Kingdom allows use of the open-year model in situations similar to those described in paragraph 20 of IAS 18.

287. Some would extend use of the open-year model to specialised entities like Lloyd's of London syndicates that currently employ the model. They observe that those entities have a long practice of using the open-year method, their financial statements are typically distributed to a small group of well-informed users, and the method is consistent with their operations.

Tentative Steering Committee View

288. *The Steering Committee does not consider either the open-year model or zero-balance model to be appropriate for most insurance activities. Financial statement users are better served by periodic reporting of revenue and expenses when the events occur that give rise to those items. However, occasions may arise in which estimates cannot be made with sufficient reliability and periodic reporting is not possible. In those*

situations, the Steering Committee favours the zero-balance model, which it considers consistent with IAS 18.

Liabilities and Assets Arising under General Insurance Contracts

289. As explained in Basic Issue 1B, the Steering Committee believes that most insurance contracts are financial instruments, because they create contractual rights or obligations that will result in the flow of cash or other financial instruments. Several items associated with those contractual rights or obligations may, depending on the view taken on the sub-issues discussed in this section, be recognised as assets and liabilities. Those items include the following:
- (a) claims payable - liabilities for insured events that have already occurred, including claims that have been reported but not paid, claims that have been incurred but not reported (IBNR) and related claim handling expenses;
 - (b) liabilities for insured events that may occur during the remaining term of existing contracts;
 - (c) acquisition costs;
 - (d) recoveries on unsettled claims, such as salvage and subrogation, and potential recoveries on future claims covered by existing insurance contracts; and
 - (e) provision for catastrophes or equalisation.
290. Basic Issue 7 discusses these potential assets and liabilities separately because that is a common way of looking at them. This does not necessarily imply that each of these items should be presented or disclosed separately in the financial statements if it qualifies for recognition; it may be appropriate to combine some of these items for presentation and disclosure purposes.
291. Assets and liabilities could be initially recognised on several dates:
- (a) the date when a contract becomes effective (incepts) , which usually coincides with receipt of initial premium;
 - (b) the date when an initial premium is received;
 - (c) the date when an insured event occurs;
 - (d) the date when a policyholder makes a claim;
 - (e) the end of the period covered by a contract; or
 - (f) the date when a claim is paid.
292. Recognition also involves recording changes in an item, including changes that result in removal from the financial statements. Changes in assets and liabilities could be

recognised on the dates described above. Alternatively, changes in assets and liabilities could be recognised in some pattern over one of the following periods:

- (a) the period over which the contract provides insurance coverage;
- (b) the period over which claims are paid; or
- (c) some longer period.

293. The pattern in which an insurance enterprise recognises changes in assets and liabilities influences, and is perhaps best understood as, the pattern in which the enterprise recognises revenue and expenses. There are several periods over which the revenue and expenses from insurance contracts could be recognised:

- (a) at the inception of the contract;
- (b) the period over which the contract provides insurance coverage;
- (c) the period over which claims are paid; or
- (d) some longer period.

Sub-issue 7B Should an Insurer Recognise a Liability for Claims Payable?

294. A liability for claims payable is usually associated with general insurance, although it may occur in certain short-duration life insurance contracts like non-renewable term insurance or long-term health insurance. While other life insurance policies give rise to claims payable for events that have already occurred, the amounts are small and present no special measurement problems. A general insurer's liability for claims payable has three elements:

- (a) claims that have been reported by policyholders but not yet paid (sometimes referred to as **active claims** or **reported claims**);
- (b) claims that will be reported in the future for events that have occurred (sometimes referred to as **incurred but not reported** or **IBNR**); and
- (c) claim handling expenses that will be incurred in the processing and resolution of claims, including legal and adjuster's fees and internal costs of processing claim payments.

295. In most jurisdictions, claims payable are recorded in the period when insured events occur, rather than in the period when policyholders submit claims for payment.¹² Most agree that the occurrence of the insured event prompts recognition of a claim liability, even though the policyholder may not become aware of the event or present a claim for some time after the event.

12 In a **claims made** policy, the insured event is the submission of a claim, regardless of the period in which the insured event occurred.

Tentative Steering Committee View

296. *In the Steering Committee's view, an insurer should recognise claims payable as a liability. An insurer's liability for claims payable includes claims that have been reported, claims incurred but not reported, and claim handling expenses. Those amounts meet the definition of a liability as outlined in IAS 37. The Steering Committee believes that the insurer has a present obligation to incur claim handling expenses relating to existing contracts because the insurer will be compelled to pay these expenses if the policyholder presents a valid claim. (And, if the insurer settles the liability by a transferring the liability to another party, the insurer will pay claim handling costs implicitly through the pricing of the transfer.) Claim handling expenses should be recognised based on the manner in which the insurer expects to settle the related claim liabilities.*

Sub-issue 7C Should an Insurer Recognise a Liability for Unexpired Risk?

297. There are two approaches to accounting for an insurer's liability for insured events that may occur during the remaining term of an existing insurance contract:
- (a) under a deferral-and-matching approach, an insurer recognises a liability for unearned premiums on the date when coverage begins under the insurance contract. Over the life of the contract, the unearned premium liability is reduced and premium revenue is recognised as income. In certain cases, the liability for unearned premiums is less than the present value of unexpired risk (that is, the present value of estimated future claim payments arising from future insured events that are covered by existing insurance contracts). In such cases, an insurer generally recognises an additional provision for premium deficiency; and
 - (b) under an asset-and-liability-measurement approach, an insurer recognises premium revenue as income when coverage begins. The insurer also recognises a provision for unexpired risk, representing the present value of unexpired risk. The provision for unexpired risk decreases as claims are paid and as the insurer is released from risk. It changes because of changes in assumptions. If the provision is determined on a discounted basis (see Sub-issue 7I), the provision increases as interest is added to the balance and changes when the discount rate changes.
298. In this Issues Paper, the term **provision for unexpired risk** refers to the entire liability recognised under an asset-and-liability-measurement approach, including the conventional provision for claims payable. In current usage, this term is sometimes used to designate the additional provision made under a deferral-and-matching approach. To avoid confusion, this Issues Paper uses the term **provision for premium deficiency** in the latter sense.
299. In some cases, the present value of unexpired risk exceeds unearned premiums. In these cases, the liability for unearned premiums plus the provision for premium deficiency equals the provision for unexpired risk and so the two approaches lead to

the recognition of the same aggregate liabilities (assuming that all other measurement assumptions are held constant between the two approaches).

- 300. In other cases, unearned premiums exceed the present value of unexpired risk. In these cases, the deferral-and-matching approach will lead to the recognition of a larger liability than the asset-and-liability measurement approach.
- 301. In particular, under the deferral-and-matching approach, the sale of a policy does not give rise to the immediate recognition of income and expense. Under the asset-and-liability measurement approach, the sale of a policy gives rise to both income and expense – and, if the policy is expected to be profitable, the income is likely to exceed the expense.
- 302. In most jurisdictions, general insurance enterprises use a deferral-and-matching approach. They recognise a liability for unearned premiums on the date that coverage begins under the insurance contract - the deferred-premium model portrayed in Illustration A1. Paragraphs 303-311 discuss the arguments put forward by supporters of the deferral-and-matching approach. Paragraphs 312-315 discuss the arguments put forward by supporters of the asset-and-liability-measurement approach.

Unearned Premiums

- 303. Those who support a deferral-and-matching approach maintain that premiums are deferred in order to match premium revenue with the periods in which it is earned. Accrual accounting (the first underlying assumption in the Framework) indicates that revenue should be reported when it is earned, rather than when cash is received.
- 304. In most jurisdictions, changes in unearned premiums are recognised as revenue over the period for which the contract provides insurance coverage. Many find this approach is consistent with the concept of an earnings process, which they consider to be complete at the end of the contract's term. They observe that it is also consistent with accounting conventions used by other commercial enterprises in similar situations, like the percentage-of-completion method discussed in paragraph 23 of IAS 18, Revenue.
- 305. Deferred premium revenue is usually amortised to the income statement on a straight-line basis over the contract term, although a different pattern of revenue recognition is sometimes adopted if the amount of insurance protection provided is not level. Some suggest that amortisation of deferred premium should be associated with the pattern in which claims are incurred; an approach they consider consistent with matching.
- 306. Those who support a deferral-and-matching approach usually suggest that an insurer should not recognise any profit on the sale of an insurance contract. In their view, profit should represent the difference between premium revenue deemed to be earned during a period and claim costs arising from insured events that occur during the same period.

Provision for Premium Deficiency

307. In most cases, the amount of unexpired risk related to future claims is less than or equal to the liability discussed in the preceding section and there is no need for additional accounting recognition. However, management sometimes determines that expected claims over the remaining term of a book of contracts will exceed the balance of unearned premium and, in a multi-year contract, future premiums as well.
308. Unexpired risk is a prospective notion - it looks forward to expectations about future claims and expenses. Those expectations may not be related to claim experience to date. For example, claims submitted to an insurer during the first half of the term of a book of contracts may exceed premium revenue recognised during that period. However, management may conclude that those claims are unusual and that claims over the remaining term will not exceed the remaining unearned premium. Illustration A8 portrays a case in which an insurer recognises a premium deficiency.
309. Illustration A8 shows the accounting by an insurer that capitalises acquisition costs. An insurer that does not capitalise acquisition costs must also consider whether a premium deficiency exists, but the situation is less likely to occur.
310. Illustration A8 ignores investment return that the insurer expects to earn over the remaining term of the contracts. In some jurisdictions, an insurer may consider anticipated investment return in determining whether or not to recognise a premium deficiency. Illustration A9 shows the same situation, but with the amount of premium deficiency based on a computation that considers anticipated investment return. As sub-issue 7I addresses discounting, this question is not considered further here.
311. A provision for premium deficiency is similar to a liability under an onerous contract, as described in paragraphs 66-69 of IAS 37. That Standard defines an onerous contract as one in which “the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.” It requires recognition of a liability for “the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.” IAS 37 also observes that before recognising a provision for an onerous contract, an enterprise “recognises any impairment loss that has occurred on assets dedicated to that contract” as required by IAS 36, Impairment of Assets. The accounting portrayed in Illustration A8 is consistent with this approach of first recognising the insurer’s inability to recover the carrying amount of deferred acquisition costs and then recognising a provision for any excess.

Provision for Unexpired Risk

312. Supporters of the asset-and-liability-measurement approach contend that the insurer’s liability should represent the amount of the insurer’s exposure under the contract, rather than a deferral of premium. Those who hold this view consider the receipt of a premium to be an obligating event that creates an uncertain liability of the insurer. An insurer incurs a liability when it receives a premium; an obligation to provide insurance coverage over the term of the insurance contract. The insurer should

therefore record a liability, rather than a revenue deferral. Income or loss results from changes in that liability, rather than a matching process.

313. From this perspective, the insurer is in the business of assuming risk and the liability recognised on receipt of premium should reflect the value of the risk assumed. In an arm's-length transaction, some argue that the amount of premium may be taken as an approximation of the value of the risk assumed, absent evidence to the contrary. However, this view allows for the possibility that the insurer might recognise net income on receipt of the premium, depending on how the value of the risk is measured.
314. If an insurer is not permitted to recognise a gain when it issues an insurance contract, an insurer that prices its products conservatively will report larger liabilities than an insurer that prices its products more aggressively. Some regard that result as counter-intuitive.
315. Illustration A5 portrays simple financial statements with a portion of the total profit from a book of general insurance contracts recognised on the date the contracts are sold.

Tentative Steering Committee View

316. *The Steering Committee considers an asset-and-liability-measurement approach more consistent than a deferral-and-matching approach with the IASC Framework and with recent International Accounting Standards, including the recently-issued IAS 37, Provisions, Contingent Liabilities and Contingent Assets. Therefore, an insurer should recognise a provision for unexpired risk, rather than provisions for unearned premium and premium deficiency. The provision for unexpired risk reflects the amount of estimated future claim payments arising from future insured events that are covered by existing insurance contracts. The provision for unexpired risk will also include an estimate of refunds that the insurer will need to pay to policyholders who cancel existing contracts during the term of the contracts. Sub-issue 7I discusses whether that provision should be determined on a present value basis.*
317. *In the Steering Committee's view, there is no logical reason to prohibit the recognition of a gain when an insurance contract is sold. However, the Steering Committee recognises that some commentators may have reservations about this change from existing practice. The Steering Committee concluded tentatively in Sub-issue 6F that the measurement of insurance liabilities should reflect the risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties. The implications of this decision are that:*
- (a) the initial measurement of the liability at inception may be less than the premium charged to the policyholder; and*
 - (b) the required margin to reflect risk will be recognised as income as the insurer is released from risks assumed at inception.*

Sub-issue 7D**Should Acquisition Costs be Deferred and Recognised as an Asset?**

318. An insurer typically incurs incremental costs to sell, underwrite, and initiate a new insurance contract. The insurer expects that premiums will be adequate to recover those costs and pay claims, leaving a profit from the book of contracts. However, acquisition costs typically cannot be recovered directly from policyholders. The amount of acquisition costs relative to premiums varies among different types of insurance and markets.
319. Regulatory accounting regimes, with their emphasis on solvency, often prohibit the reporting of deferred acquisition costs as assets. Some regulatory authorities maintain that capitalised acquisition costs cannot be converted to cash in order to pay claims and benefits and should not, therefore, be reported as assets. Others allow acquisition costs to be capitalised for general purpose financial reporting but do not regard the amounts as assets in determining whether the insurer meets required capital standards.
320. Other financial statement users acknowledge the importance of solvency, but observe that the practice of charging acquisition costs to expense when they are incurred makes it difficult to evaluate the financial performance of an insurance enterprise. The practice of charging initial costs to expense and deferring premium revenue generally results in a recognised loss on the date that a contract is issued, as portrayed in Illustration A1.

Reporting Acquisition Costs as an Asset

321. Illustration A6 shows the financial statement effect of reporting acquisition costs as an asset and amortising the balance over the term of the contract.
322. Some maintain that acquisition costs should be deferred and charged to expense in a manner consistent with the recognition of premium revenue. Those who hold this view consider it consistent with their view of deferred premium revenue. Their objective in both cases is to associate costs and related revenue and to recognise those amounts in the periods benefited. Those who hold this view also observe that when acquisition costs are immediately charged to expense, a growing company may appear financially weak, even as it adds to a base of potentially profitable insurance in force. Similarly, a company that is contracting could appear financially strong.
323. Others contend that deferred acquisition costs are similar to the costs incurred to acquire any tangible asset. The Framework defines an asset as “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.” The asset in this case is the insurer’s rights under the insurance contract. The acquisition costs are the cost of acquiring those rights. Still others maintain that deferred acquisition costs represent the costs incurred to create an internally developed intangible asset.
324. In most jurisdictions that permit deferral of acquisition costs, the amounts are reported in the balance sheet as an asset (as shown in Illustration A6). Some maintain that the asset approach is consistent with the rationale for deferring the costs. They also point to the emphasis that financial statement users place on the level of acquisition costs in

analysing an insurer's financial statements. In their view, reporting the amounts as assets facilitates that analysis by showing the amounts of deferred acquisition costs and deferred premiums rather than offsetting the two amounts.

Reporting Acquisition Costs as a Reduction of Unearned Premiums

325. Some maintain that acquisition costs do not satisfy the Framework's definition of an asset and should not be recognised as such. In paragraph 59, the Framework observes that expenditure does not necessarily create an asset. Once incurred, acquisition costs cannot be used to produce goods and services, exchanged for other assets, used to settle liabilities, or distributed to owners. The enterprise may have created an intangible asset when it entered into a book of insurance contracts, but the acquisition costs are not that asset. The intangible asset would exist even if the enterprise incurred no costs to initiate the contracts. (The question of an intangible asset associated with insurance activities is explored in greater detail in Sub-issue 11K in the context of embedded value methods.)
326. Those who hold this view acknowledge the problems that accompany the practice of charging all acquisition costs to expense while deferring all premium revenue at inception or recording a liability for policyholder benefits. However, those problems result from overstating the amount of the liability. In their view, the insurer should report the costs and their recovery on receipt of the premium. The remaining liability, then, represents the amount charged to policyholders for the insurance coverage provided, as shown in Illustration A7.
327. Some who favour reporting acquisition costs as a reduction of the unearned-premium liability observe that policyholder-benefit approaches to life insurance measurement often measure the liability for future policyholder benefits and acquisition costs in a single integrated computation. They reason that reporting the acquisition costs as an asset is unnecessary, because the objective is to report a particular pattern of reported income, with the balance sheet amounts as a residual of that computation. Reporting deferred acquisition costs as an asset, in their view, is more an accounting convention than a representation of an asset.

Tentative Steering Committee View

328. *The Steering Committee concludes that acquisition costs should be recognised as an expense, on the basis that they do not meet the Framework's definition of an asset. Also, the measurement of insurance liabilities already reflects the future cash flows to be generated by the insurance contract, so the recognition of an asset would lead to double counting.*

Sub-issue 7E If Acquisition Costs are Deferred and Recognised as an Asset, How Should they be Measured?

329. International Accounting Standards provide little guidance on amounts to be included in policy acquisition costs. Item 14 of the Appendix to IAS 18, Revenue, includes the following guidance on amounts incurred in conjunction with lending activities:

If it is probable that the enterprise will enter into a specific lending arrangement, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related direct costs, is deferred and recognised as an adjustment to the effective yield. If the commitment expires without the enterprise making the loan, the fee is recognised as revenue on expiry. [Emphasis added.]

330. Paragraph 28 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, takes a similar direct-cost approach:

Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs. [Emphasis added.]

331. Article 40 of the European Union's Insurance Accounts Directive includes the following guidance:

Acquisition costs shall comprise the costs arising from the conclusion of insurance contracts. They shall cover cost of drawing up the insurance document or including the insurance contract in the portfolio, and indirect costs, such as advertising costs or the administrative expenses connected with the processing of proposals and the issuing of the policy.

332. Some maintain that any deferred acquisition costs should include only those incremental costs incurred because of the sale of the contracts. In their view, other costs, like the cost of a permanent sales force, advertising, and allocated overhead, would have been incurred regardless and should not be capitalised.
333. Others disagree. In their view, an insurer regularly incurs certain costs as part of ongoing sales activity. A well-managed insurer sets premiums in amounts designed to recover both incremental and other allocated costs. They view capitalisation of both incremental direct and allocated direct and indirect costs as consistent with the matching of premium revenues and related costs.

Tentative Steering Committee View

334. *Given the Steering Committee's view that acquisition costs should be recognised as an expense, there is no need to specify how deferred acquisition costs should be measured.*

Sub-issue 7F How Should an Insurer Account for Recoveries Related to Claims?

335. An insurance contract usually gives the insurer certain rights in its settlement of claims. Typically, the insurer may have the right to sell (usually damaged) property acquired in settling the claim. The insurer may also have the right to pursue third parties for payment of some or all costs. These two rights are referred to respectively as **salvage** and **subrogation**. In some jurisdictions, expected recoveries are offset against claim liabilities, while in others they are reported separately as an asset.
336. IAS 37 deals with two related areas, expected disposals of assets and reimbursements. Paragraphs 51-56 of IAS 37 are as follows.

Expected Disposal of Assets

- 51. Gains from the expected disposal of assets should not be taken into account in measuring a provision.**
52. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the International Accounting Standard dealing with the assets concerned.

Reimbursements

- 53. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.**
- 54. In the income statement, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.**
55. Sometimes, an enterprise is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the enterprise or pay the amounts directly.
56. In most cases the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

Tentative Steering Committee View

337. *The receipt of salvage property from the policyholder and the subrogation of a policyholder's rights to the insurer occur at the same time as the settlement of the claim with the policyholder. Accordingly, the Steering Committee believes that an insurer should recognise its potential recoveries as a reduction in its net liability to the policyholder.*
338. *In the Steering Committee's view this is not inconsistent with IAS 37 because IAS 37 contemplates cases where an enterprise pays the creditor and then obtains a recovery by selling an asset or by claiming reimbursement from another party. However, salvage and subrogation differ because the insurer pays the claim and, at the same time, receives salvage or subrogation rights from the policyholder (rather than from another party). In other words, the insurer's obligation is to make a net settlement, comprising a cash payment less the fair value of the simultaneous receipt of salvage or subrogation rights. Market participants would take both the cash payment and the salvage or subrogation rights into account when they price the insurer's (net) obligation.*
339. *In the Steering Committee's view, an insurer should measure estimated recoveries in a manner consistent with underlying claim liabilities.*
340. *Once an insurer acquires salvage property or subrogation rights, the insurer has an asset to which the normal asset recognition and measurement criteria should be applied.*

Sub-issue 7G How Should an Insurer Account for Retrospectively-Rated Contracts?

341. Some insurance contracts allow the insurer to charge an additional premium if a policyholder's claims exceed a specified amount. A related practice is the charging of a **reinstatement premium** – an extra premium that the policyholder pays under certain contracts after a claim has occurred, so that the policy will continue to cover claims for the rest of the original contract term. Some contracts also provide for a refund to the policyholder (sometimes known as **profit commission**) if claims are less than a specified amount. Contracts that include such additional payments or refunds are often known as **retrospectively-rated** contracts. Illustrations A12-13 outline a case in which an insurer sells contracts that are subject to retrospective premiums and premium refunds based on the experience of individual contracts.
342. Another practice that raises similar issues is where the policyholder has the right to renew a contract based on experience during the current contract term. For such contracts, the policyholder is more likely to renew if experience is favourable and so the renewal rate includes a kind of implicit payment from the insurer to reflect favourable experience.

Deferral-and-Matching Approach

343. Illustration A12 portrays a deferral-and-matching approach to a retrospectively-rated contract. At inception, the insurer recognises the estimated refunds due as a liability and amortises the balance of premiums received to revenue. Estimated claims payable and estimated retrospective premiums are similarly amortised over the contract term. Claims reported and IBNR are effectively included in the amount reported as claims payable. The insurer recognises the estimated retrospective premiums receivable as either a deduction from the overall liability or as a separate asset. The insurer recognises no income or expense at inception.
344. Those who favour a deferral-and-matching approach maintain that the approach is generally consistent with accounting for other general insurance contracts. In their view, it would be inappropriate to record any additional amounts due to or from the policyholder until events allow those amounts to be measured.

Asset-and-Liability-Measurement Approach

345. Illustration A13 portrays the same retrospectively-rated contract, but with an asset-and-liability-measurement approach. At inception, the insurer recognises as a liability the estimated final amount due to policyholders and the estimated refunds due. The insurer also recognises the estimated retrospective premiums receivable as either a deduction from the overall liability or as a separate asset. The insurer recognises the entire premium received as income, the estimated claim expense, premium refunds and acquisition costs as an expense and the estimated retrospective premiums as either income or a deduction from estimated claim expense. Thus, the insurer recognises a net gain at inception. In subsequent periods, the only income and expense recognised are the effects of changes in estimates of claims, of premium refunds and of retrospective premiums, as well as investment income (and the unwinding of the discount if the liabilities are discounted).
346. Those who favour an asset-and-liability-measurement approach maintain that the contract creates assets (retrospective premiums receivable) and liabilities (premium refunds due) as contract events occur.

Tentative Steering Committee View

347. *The Steering Committee favours an asset-liability approach to accounting for retrospectively-rated contracts. The Steering Committee considers this view to be consistent with the terms of these contracts.*
348. *In some cases, such retrospective rating may eliminate insurance risk for the reinsurer or may create a non-insurance element that may need to be accounted for separately. Sub-issues IC and IE deal with such questions.*
349. *The Steering Committee notes that retrospectively-rated contracts present certain similarities to participating contracts, which are discussed in Basic Issue 9.*

Sub-issue 7H**Should Provisions for Catastrophes or Equalisation be Required, Permitted or Prohibited?**

350. Insurers rely on diversification; the risk in a large portfolio of insurance contracts is normally less than the sum of the risks on the individual contracts. However, this “spatial” diversification over a portfolio of contracts that are in force at the same time may not work well for contracts that cover infrequent but severe catastrophic losses – for example from damage to nuclear installations or satellites. Similarly, “spatial” diversification may not work well when individual claims are infrequent but highly correlated, and so severe when they do occur. An earthquake might cause losses of this kind because earthquakes are rare but when an earthquake does occur, many policyholders will claim at the same time.
351. In some jurisdictions, general insurance enterprises are permitted or required to set up **catastrophe provisions** for future claims for catastrophic losses. In other jurisdictions the practice is prohibited. The recognition and measurement of catastrophe provisions, when allowed or required, usually follows a prescribed formula that governs how much is added to the provision in any period and the conditions under which amounts may be removed from the provision and credited to income. For example, German insurers are permitted or required to set up catastrophe provisions for pharmaceutical product liability insurance: they transfer 75% of the difference between premiums and claims for the year to the provision. The maximum provision is 15 times the earned premiums. If claims exceed premiums, the provision is decreased. Illustrations A14 and A15 show the operations of an insurer over six years with and without a catastrophe provision.
352. Some countries also permit or require **equalisation provisions** to cover random fluctuations of claim expenses around the expected value of claims. For example, under the European Union’s Insurance Accounts Directive, Member States may permit insurers to constitute equalisation provisions to equalise fluctuations in loss ratios in future years or to provide for special risks. In addition, in view of the cyclical nature of claims in credit insurance, insurers are required to set up an equalisation reserve for the purpose of offsetting any technical deficit or above-average claims ratio arising in this insurance class for a financial year. For example, Germany permits equalisation provisions for certain lines (e.g. hail, credit, guarantee and fidelity insurance) using a formula based on actual experience over a number of years. If claims are below average, an amount is transferred to the provision. If losses are above average, the provision is reduced. The maximum amount of the provision reflects the standard deviation of actual losses and annual premiums.
353. Those who favour recognising catastrophe and/or equalisation provisions as liabilities base their view on one or more of the following arguments:
- (a) such provisions represent a deferral of unearned premiums because the contract is priced in such a way that part of the premium (the **catastrophe premium**) is designed to provide for events that are not expected, on average, to occur in any single contract period but are expected to occur over an entire cycle of several contract periods. Although contracts cover only one period in

form, in substance contracts are commonly renewed, giving diversification over time rather than spatially;

- (b) in some jurisdictions, such as Japan, the insurance law requires an insurer to segregate catastrophe premiums as liabilities for future catastrophe losses. These amounts are not available for distribution to shareholders and must be transferred to another insurer if the original insurer's solvency falls below the level required by supervisors. Thus, policyholders implicitly agree that the premiums they pay include these catastrophe premiums. If the catastrophe premiums are a reasonable allocation of catastrophe costs to each year and there is no room for an insurance company to deviate from the rules, the **obligating event** (that is, the event that creates a legal or constructive obligation, as described in IAS 37, Provisions, Contingent Liabilities and Contingent Assets) is not the occurrence of an insured event but the receipt of the catastrophe premium;
- (c) by matching costs and revenue over the long term, such provisions portray an insurer's long-term profitability. In particular, in years when no catastrophe occurs (or when claims are abnormally low), they avoid misleading financial statement users about the true long-term profitability of an insurer that insures such risks. Also, they show a pattern of reported income similar to one obtained through reinsurance, but with less cost and administrative burden;
- (d) such provisions enhance solvency protection by restricting the amounts distributed to stockholders. When coupled with capital restrictions, such provisions also restrict a weak company's ability to expand or enter new markets;
- (e) such provisions encourage companies to accept risks that they might otherwise decline. Some countries reinforce this encouragement with tax deductions; and
- (f) insurers sometimes have little or no discretion to withdraw from a particular region or to cease offering a particular type of insurance contract. For example, if an insurer wishes to sell automotive coverage, regulatory authorities may require that the insurer also offer hurricane coverage. While the insurer has no current obligation for hurricanes beyond the term of existing contracts, the regulatory regime has created a constructive obligation to offer hurricane coverage in the future. Thus, the insurer may have a constructive obligation to enter into future insurance contracts.¹³

354. Those who oppose recognising catastrophe and equalisation provisions base their opposition on one or more of the following arguments:

13 IAS 37, Provisions, Contingent Liabilities and Contingent Assets, defines a **constructive obligation** as "an obligation that derives from the enterprise's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, it has indicated to other parties that it will accept certain responsibilities; and (b) as a result, it has created a valid expectation on the part of those other parties that it will discharge those responsibilities."

- (a) such provisions are not liabilities under the definition in the Framework and in IAS 37, Provisions, Contingent Liabilities and Contingent Assets, because the insurer has no present obligation as a result of past events for catastrophic losses that will occur after the end of the current contract period. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. For example, at December 31 it is virtually certain that an insurance company will pay salaries for February of the next year. Those salaries are not a liability at December 31 because the obligating event (employee service) has not occurred. Similarly, an insurer may expect with considerable justification that a major storm will strike the area in which its policyholders reside. Nevertheless, the insurer does not have a liability towards policyholders until it has written policies that obligate it to make payments if a storm occurs during the period of the current contract. The recognition of catastrophe and equalisation provisions is also inconsistent with the Steering Committee's preference for a closed book approach to accounting for insurance contracts (see Sub-issue 6A);
- (b) if an insurer expects to continue writing catastrophe cover, presumably the insurer believes that the future business will be profitable. On this basis, it seems unusual to recognise a liability for future contracts (not yet written) that are expected to be profitable;
- (c) "unearned" premium should not be deferred beyond the end of the contract. The Framework states that the matching concept does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities;
- (d) the analogy with reinsurance contracts is irrelevant since reinsurance changes the insurer's risk profile;
- (e) if one objective of such provisions is to enhance solvency, the insurer should immediately record the entire amount of the provision, rather than accumulating the provision over time. Also, if diversification over time is a valid basis for accounting, above-average losses in early years should be recognised as assets. Furthermore, if future catastrophes (or unusual experience) in one period are independent of those in other periods, the insurer should not reduce the liability when a catastrophe (or unusually bad experience) occurs;
- (f) knowledgeable users understand that some events happen only occasionally and that the financial effect of those events is considerable. Recognising such provisions obscures users' ability to examine an insurer's performance in past catastrophes and does not contribute to their analysis of its current ability to withstand the effect of some future catastrophic event;
- (g) catastrophe and equalisation provisions attempt to address fluctuations in losses and the practice of diversifying risks over time. Similar issues arise in

other accounting areas. For example, some might suggest that the practice of diversifying risks over time applies equally to the lending operations of bank and other financial institutions. Lenders do not usually experience losses on the scale of those caused by a hurricane or earthquake. However, they too expect to have fluctuations over time and some maintain that they too price their loans accordingly. However, under IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions, amounts set aside for losses on loans and advances should be restricted to losses that have already been specifically identified and to potential losses that experience indicates are already present in the existing portfolio of loans and advances – it is not considered appropriate to set aside further amounts for losses on future loans and advances, even to existing borrowers;

- (h) the recognition of catastrophe and/or equalisation provisions is not the only way to limit distributions to stockholders. Other techniques, such as solvency margin requirements and risk-based capital requirements could play an important role. Another possibility would be to require insurers to segregate a portion of its equity to communicate the fact that some of their existing capital must be retained against the possibility of adverse results in future years; and
- (i) because catastrophe and equalisation provisions do not arise from a past event, there is no objective way to measure the provisions. Although some jurisdictions have developed a formula to measure such provisions, any such formula is inherently arbitrary (even if based on past experience). If no such formula is developed, insurers will have the ability to manipulate the level of reported net profit or loss.

355. Those who oppose recognising catastrophe and equalisation provisions also point to the following guidance in IAS 37, Provisions, Contingent Liabilities and Contingent Assets:

- 18. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.
- 19. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future

expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

356. Some would accept the recognition of catastrophe provisions but not equalisation provisions. Others would accept the recognition of equalisation provisions but not catastrophe provisions.

Tentative Steering Committee View

357. *In the view of a majority of the Steering Committee, catastrophe and equalisation provisions do not meet the definition of a liability articulated in IAS 37 and the Framework. However, a minority concludes that they do meet the definition. The Steering Committee would welcome comments on these issues, including whether catastrophe and/or equalisation provisions should be recognised as a liability and how best to convey information about low-frequency, high-severity risks and about random fluctuations of claims.*

Sub-issue 7I Should General Insurance Liabilities be Measured using Present Value (Discounting) Techniques?

358. The use of present value in measuring insurance liabilities varies in current practice among types of contracts and jurisdictions. Most life insurance measurements employ present value, either directly or indirectly. Most measurements of general insurance obligations do not. However, claims from some general insurance policies may not be paid, or even reported by policyholders, for several years after the end of the contract term. Insurers often incorporate assumptions about the timing of claim payments in their pricing assumptions, and reinsurance contracts often reflect the reinsurer's expectations about the time that will pass before claims are paid. Those considerations lead some to suggest that all measurements of insurance liabilities should use present value techniques.
359. Illustration A10 shows the application of present value (discounting) to claim liabilities. Illustration A11 extends the techniques to unearned premiums and deferred acquisition costs.

Views Opposed to the Use of Present Value in General Insurance Measurements

360. Some support the use of present value in accounting for life insurance and similar long-duration contracts, but oppose its use in other situations. Present value is inherent in the pricing of life insurance contracts. Few life insurers can price life insurance without considering earnings on invested assets over the period that contracts remain in force. Measurements that incorporate present value are necessary in life insurance, then, to properly attribute income and the cost of benefits to the individual years of that period. They would not, however, extend that analysis to accounting for general insurance.
361. Those who oppose use of present value techniques in general insurance maintain that an undiscounted approach properly matches the cost of claims from general insurance

with related revenue. They maintain that discounting spreads some of the cost of claims to periods beyond the end of the contract term. If claim liabilities are recorded using present value, the balance will increase with the passage of time until the claims are paid, as portrayed in the Illustrations. As a result, the enterprise recognises a cost (accrual of interest) after all of the related premium revenue has been recognised. Others take a slightly different perspective. They reason that the present value approach inappropriately accelerates recognition of investment income.

362. Some observe that the greatest obstacle to using present value is practical rather than conceptual. There is considerable uncertainty involved in estimating the amount and timing of claim payments. An insurer must address those uncertainties in measuring its liabilities, but applying present value techniques may not, in their view, produce a more useful result. They suggest that using present value presents a precision in the measurement that is not present and may diminish comparability among insurers' financial statements.
363. Finally, some suggest that the carrying amount of insurers' claim liabilities often reflects an implicit discounting (refer to the discussion on implicit and explicit approaches in Sub-issue 6B). They observe that insurers are often unable to estimate how inflation and other factors will affect the ultimate amount of claim payments. However, those factors usually increase the amount paid and reporting claims at undiscounted amounts tends to compensate for any potential underestimate of claim liabilities. However, implicit discounting is not consistent with the Steering Committee's position on the use of explicit assumptions.

Views in Favour of Using Present Value in General Insurance Measurements

364. Some consider present value consistent with a proper matching of revenue and expenses. The insurer invests premiums received and earns interest on those investments until amounts are needed to pay claims. By using present value to measure claim liabilities, the entity matches increases in the claim liability with the interest revenue earned on those investments, as portrayed in Illustration A10. Others reason that the liability should represent the insurer's costs to settle the obligation in the manner that the insurer expects to settle. One of those costs is the interest reflected in that illustration. Still others reason that a well-managed insurer incorporates present value into pricing decisions, and conclude that claim liabilities should be measured on a similar basis.
365. Those who favour the use of present value techniques agree that there is uncertainty inherent in many insurance measurements, but maintain that a present value provides more useful information than an undiscounted amount. Even if the measurement is undiscounted, the insurer cannot avoid considering the timing of claim payments if the liability measurement includes assumptions about future inflation. The expected value techniques that are inherent in many actuarial estimates can be applied to uncertainties of both timing and amount. Indeed, some argue that measurements that use present value techniques may be more reliable, and less likely to vary from one insurer to the next, than measurements based on the ultimate amount of cash flows without discounting. The present value discount tends to offset much of the effect of

inflation, and variations in estimates of cash flows far in the future are smaller when reduced to their present values.

366. Some also maintain that using present value eliminates the incentive for financial reinsurance contracts that are designed to capture, through reinsurance, the economic realities excluded from undiscounted measurements.
367. Finally, some who take an asset-and-liability measurement view observe that present value is not an end in itself. Any combination of cash flows and interest rates can be described as a present value. In their view, the resulting measurement is not useful unless the assumptions about cash flows and interest rates are consistent with some observable marketplace attribute of the obligation.

Tentative Steering Committee View

368. *The Steering Committee concludes that the use of present value in measuring general insurance claim liabilities is consistent with the Framework's emphasis on information that is relevant and decision-useful. A claim payable within one month imposes a higher economic burden than a claim of similar amount that will be paid two years in the future. The use of present value allows financial statements to provide information that distinguishes those two claims from one another. The Steering Committee also observes that IAS 37 mandates the use of present value in measurement of similar liabilities (provisions). The Steering Committee finds no basis for exempting general insurance claim liabilities from similar measurement.*

Sub-issue 7J If Present Value Techniques are Used, What Discount Rate is Appropriate

369. There remains the question of the discount rate to be used if present value techniques are employed in measuring general insurance liabilities. The selection of a discount rate is inextricably linked to the objective of the measurement and the assumptions considered in developing estimated cash flows. For example, if estimates of claim payments exclude the effects of inflation, then the discount rate should also exclude inflation. If the measurement objective is fair value, then the discount rate should be consistent with fair value. Issues surrounding the use of present value techniques are the topic of projects being conducted by standard setters in several jurisdictions, and the IASC has recently started a project on the subject of discounting.
370. *The Steering Committee concluded in sub-issue 6F that the measurement of insurance liabilities should reflect the risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties. To the extent that estimated cash flows reflect this risk, the discount rate should be a risk-free rate. To the extent that estimated cash flows do not reflect this risk, the discount rate should be a risk-adjusted rate. In developing further guidance on this topic, the Steering Committee will monitor the present value projects of IASC and national standard setters.*