Boards discuss fixed-fee service contracts

Overview

On 20 October, the International Accounting Standards Board and the Financial Accounting Standards Board (the IASB and FASB, respectively and collectively, the Boards) continued their re-deliberations of the tentative decisions in the IASB’s Exposure Draft Insurance Contracts (ED), and the FASB’s Discussion Paper Preliminary Views on Insurance Contracts (DP). At this meeting, the Boards discussed excluding certain fixed-fee contracts from the scope of the insurance contract standard, the eligibility criteria for the premium allocation approach (PPA); and certain topics on presentation and disclosure related to the statements of financial position and comprehensive income.

Fixed-fee service contracts

The definitions of insurance contracts in the ED/DP may result in more fixed-fee service contracts falling within the scope of the insurance standard. However, the Boards together with many respondents to the ED/DP, believe that certain fixed-fee service contracts should follow the revenue recognition model instead. They think that these contracts are intended mainly to provide service and not indemnification. Therefore, they should not be treated as insurance, even if the service was contingent on occurrence of an uncertain, adverse event. For these contracts, integral application of the insurance standard is seen as unduly complex and burdensome.

At this week’s meeting, the staff proposed that the guidance for the final standard should exclude fixed-fee service contracts if they exhibit all of the following characteristics:

- Contracts are not priced based on an assessment of the risk associated with an individual customer
- Contracts typically compensate customers by providing a service, rather than by paying cash

And
- The type of risk transferred relates mostly to the over-utilisation of services

What you need to know

The IASB and FASB Boards decided to exclude fixed-fee contracts that provide service as their primary benefit from the scope of the insurance standard if they exhibit certain characteristics.

- They determined that, in addition to the gross underwriting margin, an insurer should show premiums, claims and benefits on the face of the statement of comprehensive income.

The IASB intends to schedule the next Insurance Working Group meeting for the end of March 2012.
After discussing possible implications, including unintended consequences, the Boards approved the staff proposal, subject to revisions of the final language.

How we see it

Companies should consider whether their contracts for services meet the requirements of the final standard. It is possible that health organisations that provide health care services primarily in their own facilities (e.g., US Health Maintenance Organizations) may not be excluded from the insurance standard if they undermine risk. Moreover, it is also possible that extended warranties may be excluded on the basis of this decision, even though it is apparent, from prior discussions, that the Boards thought they would be in the scope of the insurance standard.

Eligibility for the PAA

During their previous meetings, the Boards discussed application of the PAA. The PPA provides a simplified measurement based on allocation of premiums over the coverage period for certain types of contracts, including many short-duration contracts. It is intended as an alternative to the building block approach (BBA), based on the presumption that an allocation model would be appropriate and less costly. In previous meetings, the Boards struggled to find criteria to determine to which types of contracts the PPA would apply. Instead of focusing on defining criteria for the PAA, the staff recommended in the papers for this meeting that insurers should take the BBA when either of the following applies:
- The BBA provides more relevant information for these portfolios than the PAA, relative to the cost of presenting that information.
- It is difficult to allocate the premium for the contract in a reliable and rational manner.

The staff papers described circumstances in which these criteria might occur.

The PAA would be applied in all other cases, although some staff members suggested that for portfolios of contracts with durations of one year or less, there should be a presumption that the PAA will be applied.

Board members noted that, compared with prior discussions and the proposals in the ED/DP; the staff recommendation reversed the order of consideration, i.e., it appears that contracts must be analysed to determine if the BBA, rather than the PAA, should be applied. Despite this change in focus, the Boards were supportive of the direction that the recommendation expressed. However, after discussing the use of the criteria, they were not satisfied that the guidance was sufficiently clear to avoid different interpretations and classification results. The Boards asked the staff to further refine eligibility based on certain conditions, such as variability in cash flows and uncertainty about the length of the coverage period. They also asked for examples that demonstrate how conditions would apply to particular types of contracts.

How we see it

The Boards are at a point where they have to decide on the direction they would like to take, but need to provide the justification to support their intentions. Expressing their objectives clearly is proving to be difficult. However, this is a practical issue and does not indicate a fundamental concern about the PAA among Board members.

Amounts measured under the PAA should be separated from amounts measured under the BBA to reflect different measurements.

Insurance firms should disaggregate the building blocks (expected future cash flows, discounting and margin components). This could be presented either in the statements of financial position (balance sheet) or in the notes.

Portfolios of insurance contracts that result in a net asset measurement should not be aggregated together with portfolios that result in a net liability.

Premiums due, to which the insurer has an unconditional right, should be disclosed separately as an asset rather than netted against the premium liability; all other rights and obligations should be presented on a net basis.

Twice decisions were made on the presentation of the PAA:
- Claims liabilities should be presented separately from liabilities for remaining coverage for contracts using the PAA.
- Premiums and claims should be presented on a gross basis, irrespective of whether the insurer has an unconditional right to those premiums. The Boards concluded that this exception would align the PAA with presentation under existing accounting practices.

The Boards also discussed the presentation of acquisition costs, but were unable to reach a common decision. The FASB voted in favor of showing a separate deferred cost asset (DAC), rather than including acquisition costs in the cash flows of the contracts. The Boards believe it is more informative to display an insurance liability and an asset related to acquisition costs separately, rather than a net amount that would sometimes be a (net) asset and other times a (net) liability. However, the IASB commented that the introduction of an asset for deferred acquisition costs would be inconsistent with the overall concept of a cash flow-oriented building block model.

Presentation of the Statement of Financial Position

Various topics related to the presentation and disclosure of insurance assets and liabilities were addressed. However, the discussions did not include unit-linked contracts or reinsurance assets.

The Boards made a number of decisions about presentation in the statement of financial position (balance sheet):

- The BBA provides more relevant information for these portfolios than the PAA, relative to the cost of presenting that information.
- It is difficult to allocate the premium for the contract in a reliable and rational manner.

The staff papers described circumstances in which these criteria might occur.

The IASB staff announced that it intends to schedule another Working Group meeting for the end of March 2012, which makes it unlikely that the next document, a revised exposure draft or a review draft of the standard, will be issued before the second quarter of 2012.

The Boards will have their next discussion on insurance during the November Board meetings; the topics for those meetings have not yet been announced.
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