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Project **Insurance Contracts**

Topic **Scope: Fixed-fee service contracts**

Purpose of this paper

1. This memorandum discusses an issue related to the scope of a future standard on insurance contracts. That issue is fixed-fee service contracts, which are those contracts that provide a service for a fixed fee that indemnifies the buyer of the service from future price increases—whether through cost inflation or level of service required to meet the contractual obligations. Consequently, the uncertainty lies in both the relevant price index and the number and severity of incidents requiring the contracted service(s).

Summary of Staff recommendations

2. The staff recommends that fixed-fee service contracts that meet the definition of an insurance contact should be in the scope of the standard for insurance contracts. This recommendation rests principally on the notion that fixed fee service contracts that meet the definition of an insurance contract should be accounted for as insurance cotracts. However, the staff also wants to remind the boards that they have reached tentative decisions specifically excluding the contracts noted in paragraph 4 from the scope of the insurance contracts standard

Structure of the Paper

3. The rest of this paper is divided into the following sections:

   (a) Background (paragraphs 4 and 5)

   (b) Definition of an insurance contract (paragraphs 6 and 7)

   (c) Fixed-fee service contracts (paragraphs 8 through 15)

Background

4. At the March 2010 joint Board meetings, the boards tentatively decided that the scope of a standard on insurance contracts will exclude:

   (a) Warranties issued directly by a manufacturer, dealer, or retailer;

   (b) Residual value guarantees embedded in a lease;

   (c) Residual value guarantees provided by a manufacturer, dealer, or retailer;

   (d) Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans; and

   (e) Contingent consideration payable or receivable in a business combination.

5. The boards expressed an initial preference that the scope of the standard should exclude fixed-fee service contracts, but noted that it would be undesirable to exclude contracts merely because they pay benefits in kind rather than in cash. The boards agreed to consider this initial preference at a future meeting (this meeting).

Definition of an insurance contract

6. The boards also tentatively decided (at the March 2010 joint board meetings) to use the current definition of an insurance contract in IFRS 4, *Insurance Contracts*, for defining an insurance contract. That definition states:

   > A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to

compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder.

7. IFRS 4 includes other definitions related to the definition of an insurance contract, including:

    (a) **Insured event:** An uncertain future event that is covered by an **insurance contract** and creates **insurance risk**.

    (b) **Insurance risk:** Risk, other than **financial risk**, transferred from the holder of a contract to the issuer.

    (c) **Financial risk:** The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Fixed-fee service contracts

8. As noted in paragraph 5, the boards had an initial preference to not include fixed-fee service contracts. Some of the reasoning cited for not including these contracts in the insurance contracts standard are:

    (a) Historically these contracts had not been considered insurance contracts.

    (b) Some types of fixed-fee service contracts provide services over a relatively short period. And typically there are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred. It seems unnecessarily burdensome to apply the building block model to those short-duration service contracts

9. Others cited the following reasons for including fixed-fee service contracts in the scope of the insurance standard:

    (a) Such contracts meet the definition of an insurance contract because the level of service depends on an uncertain event.

    (b) Some types of fixed-fee service contracts are more likely to be subject to significant changes in circumstances, for example long-term maintenance contracts. For those fixed-fee service contracts the proposed building block model would produce useful information about future cash flows and changes in those cash flows. The proposed allocation approach (unearned premium approach) for short term contracts may be an appropriate model for these contracts, particularly those with short durations..

10. The staff provided potential solutions for the boards' consideration:

    (a) Draw a distinction along the lines of short-duration versus long duration contracts

    (b) Draw a distinction between cases where the service is provided by the party that also sold the goods versus a third party providing those services

11. However, drawing such lines for scoping purposes may result in a situation that similar contracts are treated differently, or that one service provider accounts for some service contracts under the insurance contracts standard and other service contracts under another standard (eg the revenue recognition standard).

12. The staff had previously recommended that fixed-fee service contracts that meet the definition of an insurance contract remain in the scope of the forthcoming exposure draft on insurance contracts. The staff believed that because the boards are issuing an exposure draft, the most appropriate way to solicit feedback on these types of contracts is to include them in the scope.

13. However, based on the boards' deliberations, the staff has considered its recommendation and reaffirming its recommendation for the following reasons:

    (a) The focus of this project has been insurance contracts. Those contracts were defined in the DP: Preliminary Views on Insurance Contracts and will be defined again in the exposure draft and ultimately in the standard. The DP emphasized that this project was about insurance contracts and that some contracts not traditionally considered insurance contracts and contracts not issued by insurers both could be in the scope of the project. The Board has ample time during the exposure draft process to reconsider its position if significant factors are brought to the boards attention that could strongly suggest a change in the scope of the guidance.

(b) Some of the shorter term fixed fee service contracts could be eligible for the premium allocation approach (FASB has not made a decision on whether this approach can be used), these contracts would still be subject to the presentation and disclosures tailored for insurance contracts.

(c) Although specialists often are needed to measure the liabilities arising from insurance contracts the potential subjects of the standard—including fixed fee contracts—likely would have the historical information to make the same measurements with little assistance.

(d) Long-term fixed-fee services are subject to the same risk inherent in traditional insurance contracts. However, users may not be aware of the risks inherent in those long-term fixed-fee service contracts.

14. Consequently, the staff reaffirms its recommendation that fixed-fee service contracts that meet the definition of an insurance contract should be in the scope of the standard for insurance contracts.

Staff recommendation

15. The staff recommends that fixed-fee service contracts that meet the definition of an insurance contract should be in the scope of the standard for insurance

Question for the boards
Do the boards agree with the staff recommendation in paragraph 15?