Project **Insurance Contracts**

Topic **Foreign currency cash flows**

Purpose of this paper

1. This paper deals with insurance contracts with cash flows denominated in foreign currency. It discusses whether the residual margin or composite margin for such contracts should be treated as a monetary item or a non-monetary item for the purpose of foreign currency translation.

Summary of staff conclusion

2. Staff conclude in this paper that an insurance contract is a monetary item, as are each of the components of that contract (expected present value of cash flows, risk adjustment, risk margin or composite margin).

Structure of the paper

3. This paper is divided into the following sections:

   (a) Example to illustrate the issue (paragraphs 4-6)

   (b) What are monetary items? (paragraphs 7-0)

   (c) Are insurance contracts monetary items? (paragraphs 13-14)

Example to illustrate the issue

4. The issue addressed by this paper can be illustrated by an example. Suppose an insurer with the Euro as its functional currency issues a non-life insurance contract that requires the policyholder to pay a premium of US $100, and

requires the insurer to pay for loss of, or damage to an asset of the policyholder. The amount of any loss on the asset will be determined by reference to prices and costs in the US and will be expressed in US dollars. The insurer invests the premium received in an interest-bearing bank account denominated in US dollars.

Existing treatment

5. At present, under IFRS 4 *Insurance Contracts*, in this example many insurers would initially recognise the $100 received as unearned premium and amortise it to profit or loss over the coverage period. Many conclude that the unearned premium is a non-monetary item as defined by IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Consequently, the insurer would translate the $100 into Euros at the rate ruling at the time of the transaction, and would not adjust the translated amount for subsequent changes in the exchange rate.

6. However, because the premium is included in a bank account that is a monetary asset, its carrying amount would reflect subsequent changes in the exchange rate. As a result, the insurer will report gains and losses on the premium held in the bank account, even though the insurer expects that it will use a large proportion of that premium to pay claims denominated in US dollars. Some argue that this result is an accounting mismatch and does not reflect the economic substance of the transaction. They believe that a more faithful representation of the transaction would arise from treating the unearned premium as a monetary item, retranslated as exchange rates change.

What are monetary items?

IFRSs

7. IAS 21 defines monetary items as “units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.” Paragraph 16 of IAS 21 provides further discussion:

> "The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: pensions and other employee benefits to be paid in cash; **provisions that are to be settled in cash**; and cash dividends that are recognised as a liability. Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: **amounts prepaid for goods and services** (eg prepaid rent); goodwill; intangible assets; inventories; property, plant and equipment; and provisions that are to be settled by the delivery of a non-monetary asset. [emphasis added]

US GAAP

8. Similarly, US GAAP contains the following guidance in ASC paragraph 830-10-45-18:

> All of the following are common nonmonetary balance sheet items and related revenue, expense, gain, and loss accounts that shall be remeasured using historical rates to produce the same result in terms of the functional currency that would have occurred if those items had been initially recorded in the functional currency:
>
> a. Marketable securities carried at cost, including:
>
>   1. Equity securities
>
>   2. Debt securities not intended to be held until maturity.
>
> b. Inventories carried at cost
>
> c. **Prepaid expenses such as insurance, advertising, and rent**
>
> d. Property, plant, and equipment
>
> e. **Accumulated depreciation on property, plant, and equipment**

f. Patents, trademarks, licenses, and formulas

g. Goodwill

h. Other intangible assets

i. **Deferred charges and credits, except policy acquisition costs for life insurance companies**

j. Deferred income

k. Common stock

l. Preferred stock carried at issuance price

m. Revenues and expenses related to nonmonetary items, for example:

1. Cost of goods sold

2. Depreciation of property, plant, and equipment

3. Amortization of intangible items such as patents, licenses, and so forth

4. **Amortization of deferred charges or credits except policy acquisition costs for life insurance entities.** [emphasis added]

9. ASC Topic 255 *Changing Prices* also discusses monetary items, although in a different context, namely reporting the effects of changing prices. It defines:

(a) a monetary asset as "money or a claim to receive a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods or services".

(b) a monetary liability as "an obligation to pay a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods and services."

10. Paragraph 255-10-55-1 gives the following as examples of monetary items:

(a) Life insurance policy reserves ("These represent portions of policies' face values that are now deemed liabilities.")

(b) Deferred life insurance policy acquisition costs ("Such costs represent the portion of future cash receipts for premiums that is recognized in the accounts and are sometimes viewed as an offset to the policy reserve.”)

(c) Property and casualty insurance loss reserves

11. Paragraph 255-10-55-1 gives the following as examples of non-monetary items:

(a) Unearned property and casualty insurance premiums (“These are nonmonetary because they are principally obligations to furnish insurance coverage. The dollar amount of payments to be made under that coverage might vary materially due to changes in specific prices.”)

(b) Deferred property and casualty insurance policy acquisition costs related to unearned premiums

12. ASC paragraph 255-10-55-7 includes the following guidance: “… Some assets and liabilities, of which the net investment in the lease is a good example, are combinations of claims to (or obligations of) fixed amounts and claims to (or obligations of) variable amounts. Ideally, those claims should be separated for purposes of classifying them as monetary and nonmonetary. However, if the information necessary to make the separation is not available or is impracticable to obtain, such items need not be divided into monetary and nonmonetary components and would be classified according to their dominant element. …”

Are insurance contracts monetary items?

13. The proposed model measures an insurance contract as a sum of:

(a) the expected present value of the future cash flows [plus a risk adjustment], and

(b) a composite [or residual] margin.

14. In the light of the guidance quoted above, staff conclude as follows:

(a) The expected present value of the future cash flows is a monetary item.

(b) The risk adjustment is determined by the amount, timing and uncertainty of those cash flows. Therefore, it is also a monetary item.

(c) The residual or composite margin is akin to an amount pre-paid for goods and services. On the face of it, therefore, those margins are non-monetary items. However, it would be more consistent to treat the entire package (cash flows plus [risk adjustment and residual margin] or plus [composite margin]) as denominated in a single currency. Therefore, the residual or composite margin should be regarded as a monetary item.

(d) The boards are considering a simplified approach for pre-claims liabilities of short-duration contracts. The simplified approach uses the unearned part of the consideration received to measure the pre-claims liability. At inception, that measurement can be viewed as made up of three components (cash flows plus [risk adjustment and residual margin] or [composite margin]). If each of those components is a monetary item, the whole package is also a monetary item.

(e) As already noted above, IAS 21 and ASC topics 830 and 255 treat items such as prepayment and deferred charges or credits as non-monetary items. However, the boards have not discussed in the revenue recognition project whether performance obligations measured using an allocation of the customer consideration approach should be regarded as monetary items. This paper does not ask that question. Nevertheless, in the staff's view, the conclusion in (d) does not depend on the answer to that question. Although the simplified measurement approach results in a measurement similar to the revenue recognition approach, that is not the rationale for its use. Instead, the rationale is that it is a short-cut designed to achieve something broadly similar to the full measurement using the building blocks. Therefore, if the measurement using the building blocks is a monetary item, the short-cut proxy for that measurement is also a monetary item.

Staff conclusion and question for the boards

The staff conclude in paragraph 14 that a insurance contract is a monetary item, as are each of the components of that contract (expected present value of cash flows, risk adjustment, risk margin or composite margin).

Do the boards agree?