Project **Insurance contracts**

Topic **Unearned premium model**

Purpose of this paper

1. One of the measurement approach candidates is an unearned premium approach. This paper discusses whether an unearned premium approach should (or could) be applied to insurance pre-claims liabilities arising from short-duration contracts.

2. All other insurance liabilities (including claims liabilities) would be measured using whichever of the other candidates is selected by the boards. [The FASB will discuss separately at a future meeting whether claims liabilities of non-life contracts could be measured by using undiscounted cash flows with no margin. The IASB already rejected such an approach in February 2009].

3. This paper argues that:

   (a) for some insurance liabilities an unearned premium approach would provide decision-useful information and therefore should be permitted for such liabilities

   (b) liabilities eligible for an unearned premium approach should be identified by factors that may indicate when the additional costs of applying a prospective explicit building block approach may exceed the benefits of such an approach

   (c) the trigger (and the measurement basis) for a liability adequacy test under the unearned premium approach should be consistent with the selected measurement approach for all (other) insurance liabilities.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

4. This paper is divided into the following sections:

   (a) What is an unearned premium approach? (Paragraphs 6 – 10)

   (b) Why consider an unearned premium approach? (Paragraphs 11 – 16)

   (c) Permit or require an unearned premium approach? (Paragraphs 17 – 21)

   (d) For which liabilities can an unearned premium approach be applied? (Paragraphs 22 – 24)

   (e) What is the trigger for the liability adequacy test? (Paragraphs 25 – 29)

   (f) Other issues on unearned premiums (paragraphs 30 – 34)

      (i) Time value of money (paragraphs 30 – 32)

      (ii) Acquisition costs (paragraphs 33 – 34).

5. This paper does not address:

   (a) whether an insurer should account for insurance contracts as a single (net) contract position rather than account for future cash outflows as a liability and future cash inflows as an asset.

   (b) whether claims liabilities arising from non-life contracts could be measured by using undiscounted cash flows with no margin.

What is an unearned premium approach?

6. The insurer fulfils its performance obligation continuously over the coverage period by transferring to the customer an asset (the insurance coverage). The coverage period is the period in which the insurer is standing ready to pay any valid claims made by the policyholder (the pre-claims period).

7. As the insurer is released from risk, the related part of the premium (the customer consideration) is regarded as earned and recognised as revenue. The unearned part of the premium (possibly less acquisition costs, see paragraphs 33-34) is recognised as a liability; the unearned premium model measures an insurance liability at the unallocated part of the premium over the remaining coverage period.

8. The unearned premium approach therefore allocates the original transaction price (the insurance premium) over the pre-claims period. This approach is similar, and perhaps identical, to the allocated transaction price approach proposed in the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*.

9. The unearned premium can be analysed as the sum of the following implicit building blocks:

   (a) cash flows as implied by the premiums, locked-in at inception;

   (b) time value of money as implied by the premiums received, locked in at inception;

   (c) a margin as implied by the premium, also locked-in at inception.

10. Because the premium may not be sufficient to cover the obligation, a liability adequacy test (onerous contract test) is required at each reporting period. If the contract is deemed to be onerous, the measurement of the performance obligation would be updated, paragraphs 25 - 29 discuss this topic in more detail.

Why consider an unearned premium approach?

11. The outcome of an insurance contract can be highly variable because uncertainty is an inherent characteristic of insurance contracts and some of those contracts cover many reporting periods. Staff therefore believes that, in order to provide useful information, a measurement for insurance contracts **conceptually** should report promptly the effect of changes in circumstances. Both boards have already confirmed this by deciding to use updated cash flows in measuring insurance liabilities.

12. In previous meetings, staff deliberately added ‘conceptually’ to keep open the possibility of considering a simplification for the pre-claims liabilities of short-

duration contracts.[1] During the short coverage period of such contracts, an insurer is unlikely to become aware of events that could cause significant changes in the expected cash flows. If significant changes do occur in such a short period, they are likely to be adverse changes and a liability adequacy test should capture them. The unearned premium could therefore provide a measure that is obtainable with less cost and effort.

13. This analysis is consistent with the boards' view in the discussion paper on revenue recognition that the allocated transaction price approach proposed in that DP might provide decision-useful information for some contracts but not all of them.

14. The Discussion Paper *Preliminary Views on Insurance Contracts* (DP) discussed the possibility of using an unearned premium as a reasonable approximation to an explicit measurement using the three building blocks. The DP expressed the view that an insurer should not assume the unearned premium to be a reasonable approximation to a building block approach without testing it, particularly if a contract is likely to be highly profitable or highly unprofitable, or circumstances have changed significantly since inception.

15. Some respondents to the DP favoured an unearned premium approach for the pre-claims liabilities of non-life insurance contracts. They noted that most existing accounting models use an unearned premium approach for these liabilities. Therefore, users are accustomed to analysing information about earned premiums and incurred claims to derive important ratios, such as claims ratios[2] and combined ratios.[3] We have been informed repeatedly that users find such information and these ratios very useful.

16. We note that the use of the unearned premium model affects not only the measurement of a liability, but also the presentation in the balance sheet and the

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[1] Although in paragraph 2 we noted that the FASB will discuss separately at a future meeting whether claims liabilities of non-life contracts could be measured by using undiscounted cash flows with no margin.
[2] Incurred claims divided by earned premiums.
[3] (Incurred claims plus expenses) divided by earned premiums.

performance statement as well as accompanying disclosures. For example, the unearned premium approach in most cases measures the building blocks in an implicit way and would therefore not provide explicit information about the building blocks.

Question for the boards
Do you agree that for some insurance liabilities an unearned premium approach would provide decision-useful information and therefore should be considered for such liabilities? (the staff will specify those liabilities in more detail later in this paper)

Permit or require an unearned premium approach?

17. Staff identified two approaches for using the unearned premium as a measurement for insurance contracts:

    (a) **require** it as the selected measurement approach for the pre-claims period of short-duration insurance contracts instead of the measurement approach selected for all other insurance liabilities

    (b) **permit** it as a measurement approach for the pre-claims period of these contracts as an alternative to the measurement approach selected for all insurance liabilities.

18. Requiring an unearned premium approach (option (a)) would arguably put the most pressure on the line between short-duration insurance contracts and other insurance contracts. Furthermore, some insurers already use a prospective approach (one based on the expected present value of cash flows, with a margin); users of the financial statements of those insurers may consider an unearned premium approach as a step backwards. Moreover, it seems odd to preclude insurers from using the measurement approach to be selected by the boards for all other insurance liabilities

19. Permitting the use of unearned premium (option b) gives the insurer a choice. An accounting option adds complexity. However, an unearned premium method is currently widely used within the insurance industry for short-duration pre-claims liabilities. Allowing the insurer to use such an approach would not

disturb existing practice that users appear to find useful. Furthermore, permitting unearned premium would put less pressure on a line between short-duration pre-claims liabilities and other insurance liabilities than an approach that requires unearned premium. Moreover, some insurers who issue specialised contracts covering highly uncertain and very costly events (eg satellite launches) believe that an unearned premium approach is more practicable than requiring explicit cash flow estimates at inception (although explicit cash flow estimates would still be needed for claims liabilities).

20. For the reasons mentioned in paragraphs 18 and 19 staff prefers an approach that permits the use of unearned premium for pre-claims of short-duration contracts rather than requiring it.

21. Staff considered whether it would be sufficient for the standard simply to point out that there may be circumstances when unearned premium could be used when it is a reasonable approximation, within the normal bounds of materiality, of the measurement otherwise required by the standard. However, we prefer to include unearned premium as an explicitly permitted measurement approach because it may help preparers to communicate and users to understand the measurement used for the pre-claim liabilities of short-duration contracts. Furthermore, it fits better in how both preparers and users look at unearned premium in current accounting.

Question for the boards
Do you agree that an unearned premium approach should be permitted rather than required?

For which liabilities can an unearned premium approach be applied?

22. One way to define the liabilities that are eligible for an unearned premium approach is to explicitly define the notion of pre-claim liabilities of short-duration contracts; a line will be drawn between those liabilities and all other liabilities. However, it would be difficult to draw an exact line; any line is bound to be somewhat arbitrary and inconsistent with a principles-based approach.

23. Another way would be to include in the future insurance standard a number of factors that may indicate when the additional costs of applying a prospective explicit building block approach may exceed its benefits. In other words, from a cost-benefit perspective an unearned premium approach is less onerous to apply and does not generate significantly lower benefits. These factors could be defined broadly along the lines of pre-claims liabilities of short-duration contracts, such as:

    (a) duration of the coverage period, for example 12 months or less

    (b) the insurer is unlikely to become aware of events during the coverage period that could cause significant decreases in the expected cash out flows

    (c) no embedded options or guarantees.

24. An approach that builds on factors help an insurer assess when an unearned premium approach can be used, as opposed to drawing a 'bright line' between different types of contracts. This is in our view more consistent with a principles based approach. Such factors mean that a 'rule' for drawing the line does not have to be developed, but still allow the insurer to determine without undue cost whether it can apply an unearned premium approach to some of its liabilities (ie without burdensome testing).

Question for the boards
Do you agree that liabilities eligible for an unearned premium approach should be identified by factors that may indicate when the additional costs of applying a prospective explicit building block approach may exceed its benefits rather than drawing a bright line between those liabilities and other insurance liabilities? If not, how would you determine insurance liabilities for which an insurer could use an unearned premium approach? Do you have any comments on the factors included in paragraph 23?

What is the trigger for the liability adequacy test?

25. If the boards adopt the unearned premium approach for some types of insurance contract, they will need to define the trigger (and measurement basis) for the liability adequacy test. Two obvious candidates are:

    (a) the onerous contract test included in the discussion paper on revenue recognition

    (b) the prospective measurement approach used for all (other) liabilities [the boards have yet to conclude on this approach].

26. Selecting an onerous contract test included in the discussion paper on revenue recognition would ensure that an allocated transaction price approach in one standard uses the same trigger as an allocated transaction price approach in another standard. However, it may cause discontinuities with the measurement of all (other) insurance liabilities; particularly on transition from pre-claims liabilities into a claims liability.

27. Selecting the measurement approach used for all (other) liabilities maximises consistency in the measurement in of insurance contracts. However, some insurance measurement candidates include a (risk) margin that is separately measured and updated. Including such a margin in the onerous contract test could significantly increase the frequency of remeasurements in practice. Some might say that this, in effect, would undo the simplicity of an allocation of the original transaction price.

28. Staff acknowledges that choosing the prospective measurement approach used for all (other) liabilities as the basis for the liability adequacy test could undo some of the simplicity of an unearned premium approach. Furthermore, it would mean that the trigger for the onerous test would differ from the one used in the revenue recognition project. However, staff believes it is critical to have a measurement basis that is as consistent as possible for the various parts of the insurance liability. As a result, staff concludes that (b) the measurement approach used for all (other) liabilities should apply as the basis for the liability adequacy test.

29. The boards have decided tentatively not to recognise day one gains. Thus, if the trigger for the liability adequacy test is consistent with the measurement approach for all other liabilities, at inception the unearned premium model ends up with the same outcome as the other candidates in all cases.

Question for the boards
Do you agree that the trigger (and the measurement basis) for a liability adequacy test under the unearned premium approach should be consistent with the selected measurement approach for all (other) liabilities? If not, what basis would you use?

Other issues on unearned premiums

Time value of money

30. In their project on revenue recognition, the boards have decided tentatively:

    (a) that an entity's net contract position should reflect the time value of money whenever the effect would be material. To be consistent with this decision, an entity will accrete interest on its unearned premium liability (if the effect is material).

    (b) to provide guidance on materiality in this context.

    (c) that the discount rate should be the rate at which the entity and its customer would have entered into a financing transaction that did not involve the provision of other goods and services.

31. In current practice the unearned premium is usually applied in a manner that does ignore time value of money for subsequent measurement (with time value of money considered implicitly at inception). However, staff has so far not identified a reason why an insurer should not apply time value of money to an unearned premium. This would mean that an insurer should assess whether the effect of the time value of money is significant for the 'net' unearned premium (ie future cash outflows as a liability less future cash inflows), presumably using the guidance that will be developed in the revenue recognition project. If the

insurer would conclude that the effect of time value of money is material to the unearned premium, it should accrete interest to it.

32. Staff will seek input from the Working Group on this and will come back to this when it asks the boards to conclude on the discount rate. At that stage staff will also discuss whether for the unearned premium approach the discount rate should be the rate at which the entity and its customer would have entered into a financing transaction or something else.

Acquisition costs

33. The allocated transaction price approach as proposed in the discussion paper on revenue recognition does not allow for any day one revenue to cover acquisition costs (or deferral of those costs). This could result in significant day one losses for insurance contracts, even for those that are of a short duration.

34. In April 2009, the IASB decided tentatively that an insurer should recognise as revenue on day one the part of the premium that covers the acquisition costs. However, the FASB decided tentatively that an insurer should not recognise any revenue at inception. Staff will bring back the issue of acquisition costs at the joint meeting in July. Based on the outcome of the joint meeting, staff will further address the issue of acquisition costs in an unearned premium approach.