Project **Insurance Contracts**

Topic **Modified measurement approach for short-duration contracts**

Objective

1. The purpose of this paper is to discuss whether the proposed modified approach for short duration contracts is an appropriate a simplification of the building block approach. This paper also discusses the scope criteria and other provisions that relate only to the proposed modified approach, including interest accretion and the application of an onerous contract test. Some have argued these provisions complicate the model.

Simplified vs. Different

2. The proposed modified measurement approach is akin to the accounting model for short-duration insurance contracts in most countries (with discounting in several countries). The proposed modified measurement approach was initially developed to simplify the measurement of the preclaims liability for short-duration contracts. A preclaims liability would be measured using an unearned premium approach that is consistent with the customer consideration approach in the boards' exposure draft on revenue recognition. Theoretically, the unearned premiums represent a reasonable approximation of the present value of the fulfilment cash flows and the residual margin (and, under the FASB's preliminary views, the present value of the probability-weighted estimate of net cash flows and the composite margin).

3. As seen in the Appendix, the same insurance liability is initially recognised whether the building block approach or the modified approach is applied.

4. Under the IASB model, if there are no changes in estimates, the subsequent measurement of the insurance liability and the amounts recognised in profit or

loss each period are the same under the two approaches. However they differ if there are changes in estimates.

5. Under the FASB model, the subsequent measurement of the insurance liability and the amounts recognised in profit or loss each period differ between the two approaches, regardless of whether the estimates change. This is because, in the modified approach, the implicit composite margin included in the preclaims liability is amortized over the period the premiums are recognised. In contrast, the composite margin included in the building block approach is amortized over the coverage and claims paying period.

Questions
1. Does the modified approach represent an appropriate simplification of the building block approach given the different results emerge between the two approaches as described in paragraphs 3-5?

Other measurement proposals for short-duration contracts

Interest accretion

6. Under the IASB's proposals for the proposed modified approach, interest would be accreted on the carrying amount of the insurance contract if the effect of the time value of money is material. This proposal is consistent with the proposals in the exposure draft on revenue recognition, which would require an entity to accrete interest on the transaction price.

7. The accretion of interest reflects the fact that the entity rationally would have charged a different cash amount if the contract had stipulated earlier or later payment by the customer. Thus, accretion of interest shows the effect of the financing separately from the revenue from goods or services.

8. The FASB has not determined whether interest would be accreted on the carrying amount of the preclaims liability.

Onerous contract test

9. Under the IASB's proposals for the modified approach, a contract is considered onerous if the present value of the fulfilment cash flows (which includes the risk adjustment margin) exceeds the carrying amount of the preclaims obligation. However, several stakeholders have asked whether this quantitative onerous test

would be applied in all cases or whether a qualitative analysis could be applied first to determine whether further testing is necessary.

10. Requiring the onerous contract test increases the complexity of the modified approach. Additionally, the proposed onerous contract test has several differences from current requirements:

    (a) It includes the risk adjustment margin in the present value of the fulfilment cash flows, increasing the likelihood that the contracts will be onerous.

    (b) It does not include investment income in the cash inflows of the calculation. On the other hand, the cash outflows are discounted to reflect the time value of money.

    (c) It evaluates contracts at the portfolio level by similar date of initial recognition (which some stakeholders believe differs from current guidance that groups contracts consistent with an entity’s manner of acquiring, servicing, and measuring the profitability of its insurance contracts).

11. However, despite these complexities, the onerous contract test provides the following benefits:

    (a) It results in more timely recognition of losses.

    (b) It is consistent with current practice.

12. The FASB has not determined how the onerous test would be applied to the preclaims liability.

Questions
2. Do you think that the proposal to accrete interest on insurance contracts within the scope of the proposed modified approach provides useful information to stakeholders? Why or why not? 3. Do you think that the risk adjustment should be included in the onerous contract test? Why or why not? 4. At what level should contracts be aggregated for applying the onerous contract test?

Scope

13. Under the proposals, a modified approach would be required for preclaims liabilities arising under short-duration contracts that meet both of the following conditions:

    (a) The coverage period of the insurance contract is approximately one year or less.

    (b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives.

14. Accordingly, insurers would account differently for contracts that are similar in nature but have different coverage periods. For example:

    (a) Some contracts that are currently accounted for under short-duration guidance (for example, some commercial property and liability insurance and surety bonds that have coverage periods longer than one year) would be outside the scope of the modified approach.

    (b) Some contracts currently accounted for under a long-duration model would be accounted for under the modified approach. For example, yearly renewable term reinsurance contracts[1] currently are accounted for under a long-duration model. However, because the duration of these reinsurance contracts is one year, they would be within the scope of the modified approach.

[1] Yearly renewable term contracts are a form of life reinsurance under which the mortality or morbidity risks, but not the permanent plan reserves, are transferred to the reinsurer for a premium that varies each year with the amount at risk and the ages of the insureds. The amount of reinsurance, which may change annually, is generally the amount of insurance provided by the policy in excess of the primary insurer's reserve.

15. Some believe that the proposed modified approach should apply to a type of contract rather than for a specified period of coverage so that contracts that provide similar coverage would use the same measurement approach. Additionally, these stakeholders note that defining the scope of the proposed modified approach based on type of coverage has the added benefit of being consistent with requirements in most jurisdictions.

Questions
5. Do you think the modified approach should apply to contracts based on the duration of the coverage period or the type of insurance contract issued? 6. If the modified approach were to apply to contracts based on type of insurance contract issued, what criteria should be used?

Permit vs. Require

16. The Boards considered whether to permit or require the use of the modified approach for contracts within its proposed scope. They propose that use of the modified approach should be required.

17. Some state that permitting the use of the proposed modified approach, rather than requiring it, would alleviate some of the concerns about eligibility for the modified approach. Those with this view would also allow an entity that writes several types of insurance contracts and/or contracts of varying lengths to account for all of its contracts in accordance with one model (that is, the building block approach). They argue this would enhance comparability within an entity.

18. However, opponents of that view believe allowing an entity to elect the use of the modified approach would undermine comparability across entities, and consider this a more important comparison.

Questions
7. Do you think the modified approach should be permitted or required for contracts within its scope?

Contract set-up

1 year contract written on 1 Jan
Premiums receivable on first day of each month evenly throughout the year
Ignored discounting of premiums
Ignore interest for accretion purposes
Incremental acquisition costs are paid at inception
No claims paid
Assume risk adjustment is adjusted only as claims paid

Premiums		1,200
Loss ratio	63%	750
Discount rate	4%	30
Incremental acquisition costs	15%	180
Non-incremental acquisition costs	3%	36
Risk adjustment	19%	144

Modified Approach

Pre-claims obligation (PCO)		
Premiums at inception	100	
PV of future premiums (ignoring discounting)	1,100	
Incremental acquisition costs	- 180	
PCO	1,020	
Pre-claims liability (PCL)		
PCO	- 1,020	
Less PV of future premiums	1,100	
PCL	80	

Caculation of liability adequacy at inception
Discounted future cash flows:

Day 1 premium	1,200
Present value of future claims and expenses	-720
Incremental acquisition costs	-180
Net discounted future cash outflows	300
Risk adjustment	-144
Present value of the fulfilment cash flows (PVFCF)	156

Therefore no day 1 loss to be recognised

Building Block Approach

	Insurance liability at initial recognition	Insurance liability immediately after initial premium received
Expected cash in-flows	1,200	1,100
Expected cash out-flows	- 750	- 750
Incremental acquisition costs	- 180	
Discounting	30	30
Composite margin	300	
Risk adjustment	- 144	- 144
Residual margin	156	- 156
Insurance contract liability		80

Journal entries on 1 Jan

Modified Approach

Dr	Cash	100	
Cr	Pre-claims liability		100
Receipt of initial premium			
Dr	Pre-claims liability - acqn cost offset	180	
Cr	Cash		180
Payment of incremental acquisition costs			
Dr	Expenses P&L	36	
Cr	Cash		36
Payment of non incremental acquisition costs			

Building Block Approach

		Both	IASB	FASB
Dr.	Cash	100		
Cr	Insurance contract liability- ECF		- 200	- 200
	Insurance contract liability - Risk Adj.		144	
	Insurance contract liability - RM/CM		156	300
Receipt of initial premium and recording of PV expected cash flows plus risk adjustment and residual margin or composite margin				
Dr	Insurance contract liability-acqn cost offse	180		
Cr	Cash		180	
Payment of incremental acquisition costs				
Dr	Expenses P&L	36		
Cr	Cash		36	
Payment of non incremental acquisition costs				

Balance sheet at 1 Jan

Modified Approach

Assets	
Cash	-116.0
	-116.0
Liabilities and equity	
Net pre-claims liability	-80.0
Net income for the year	-36.0
	-116.0

Building Block Approach

Assets		
Cash	-116.0	
	-116.0	
Liabilities and equity		
Insurance contracts liability-ECF	-380.0	-380.0
Insurance contracts liability-Risk Adju	144.0	
Insurance contracts liability-RM/CM	156.0	300
Net income for the year	-36.0	-36.0
	-116.0	-116.0

Receivable for expected future cash in flows of 1,100 is offset against the same amount for the pre-claims liability

Journal entries at 30 June

	Dr	Cash	500	
	Cr	Pre-claims liability		500
	Receipt of premiums for Feb-June			
	Dr	Pre-claims liability	600	
	Cr	Premium revenue P&L		600
	Recognition of premium revenue for first 6 months			
	Dr	Amortisation of incremental acquisition c	90	
	Cr	Pre-claims liability (Acquisition cost offset)		90
	Amortisation of incremental acq. Costs			
	Dr	Claims and benefits expenses - P&L	360	
	Cr	Claims liability		360
	Establishment of claim liability under building blocks for post-claims perio			
	Dr	Claims and benefits expenses - P&L	72	
IASB only	Cr	Claims liability - risk adjustment		72
	Establishment of risk adjustment for post-claims period			

	Dr	Cash	500	
	Cr	Insurance contract liability		500
	Receipt of premiums for Feb-June			
	Dr	Insurance contract liability-amort of RM	78	
IASB only	Cr	Risidual Margin - P&L		78
	Amortization of Residual Margin			
	Dr	Insurance contract liability-amort of CM	92	
FASB only	Cr	Composite Margin - P&L		92
	Amortization of Composite Margin			

Composite margin				*300*
(premiums received+claims paid)	*600*	*0*	*600*	
(expected cash inflows + expected cash outflov	*1,200*	*750*	*1,950*	
				31%
Current year amortization of composite margin				*92*
Residual margin				*156*
Passage of time				*50%*
Current year amortization of residual margin				*78*

Balance sheet at 30 June

	IASB	FASB
Assets		
Cash	384	
	384	
Liabilities and equity		
Net pre-claims liability	-90	- 90
Claims liability - expected cash flow	360	360
Claims liability - risk adjustment	72	
Net income for the year	42	114
	384	384

	IASB	FASB
Assets		
Cash	384	
	384	
Liabilities and equity		
Insurance contract liability - expected cash flow	120	120
Insurance contract liability - risk adjustment	144	
Insurance contract liability-RM/CM	78	208
Net income for the year	42	56
	384	384

Journal entries at 31 Dec

	Dr	Cash	600	
	Cr	Pre-claims liability		600
	Receipt of premiums for July-Dec			
	Dr	Pre-claims liability	600	
	Cr	Premium revenue P&L		600
	Recognition of premium revenue for second 6 months			
	Dr	Amortisation of incremental acquisition c	90	
	Cr	Pre-claims liability (Acquisition cost offset)		90
	Amortisation of incremental acq. Costs			
	Dr	Claims and benefits expenses - P&L	360	
	Cr	Claims liability		360
	Establishment of claim liability under building blocks for post-claims perio			
	Dr	Claims and benefits expenses - P&L	72	
IASB only	Cr	Claims liability - risk adjustment		72
	Establishment of risk adjustment for post-claims period			

	Dr	Cash	600	
	Cr	Insurance contract liability		600
	Receipt of premiums for July-Dec			
	Dr	Insurance contract liability-amort of RM	78	
IASB only	Cr	Residual Margin - P&L		78
	Amortization of Residual Margin			
	Dr	Insurance contract liability-amort of CM	92	
FASB only	Cr	Composite Margin - P&L		92
	Amortization of Composite Margin			

Composite margin				*300*
(premiums received+claims paid)	*1200*	*0*	*1200*	
(expected cash inflows + expected cash outflov	*1200*	*750*	*1950*	
				62%
Current year amortization of composite margin				*185*
Residual margin				*156*
Passage of time				*100%*
Current year amortization of residual margin				*156*

Balance sheet at 31 Dec

	IASB	FASB
Assets		
Cash	984	
	984	
Liabilities and equity		
Net pre-claims liability	0	-
Claims liability-ECF	720	720
Claims liability - risk adjustment	144	
Net income for the year	120	264
	984	984

	IASB	FASB
Assets		
Cash	984	
	984	
Liabilities and equity		
Insurance contract liability-ECF	720	720
Insurance contract liability - risk adjustment	144	
Insurance contract liability-RM/CM	0	115
Net income for the year	120	149
	984	984

Contract set-up

1 year contract written on 1 Jan
Premiums receivable on first day of each month evenly throughout the year
Ignored discounting of premiums
Ignore interest for accretion purposes
Incremental acquisition costs are paid at inception
No claims paid
Assume risk adjustment is adjusted only as claims paid

Premiums		1,200
Loss ratio	63%	
		750
Discount rate	4%	
		30
Incremental acquisition costs	15%	
		180
Non-incremental acquisition costs	3%	
		36
Risk adjustment	19%	
		144

Modified Approach

Pre-claims obligation (PCO)		
Premiums at inception		100
PV of future premiums (ignoring discounting)		1,100
Incremental acquisition costs	-	180
PCO		1,020
Pre-claims liability (PCL)		
PCO	-	1,020
Less PV of future premiums		1,100
PCL		80

Caculation of onerous contract test at inception	
Discounted future cash flows:	
Day 1 premium	1,200
Present value of future claims and expenses	-720
Incremental acquisition costs	-180
Net discounted future cash outflows	300
Risk adjustment	-144
Present value of the fulfilment cash flows (PVFCF)	156
Therefore no day 1 loss to be recognised	

Building Block Approach

		Insurance liability at initial recognition		Insurance liability immediately after initial premium received
Expected cash in-flows		1,200		1,100
Expected cash out-flows	-	750	-	750
Incremental acquisition costs	-	180		
Discounting		30		30
Composite margin		300		
Risk adjustment	-	144	-	144
Residual margin		156	-	156
Insurance contract liability				80

Journal entries on 1 Jan

Modified Approach

		Dr	Cr
Dr	Cash	100	
Cr	Pre-claims liability		100
Receipt of initial premium			
Dr	Pre-claims liability - acqn cost offset	180	
Cr	Cash		180
Payment of incremental acquisition costs			
Dr	Expenses P&L	36	
Cr	Cash		36
Payment of non incremental acquisition costs			

Building Block Approach

		Both		IASB		FASB
Dr.	Cash	100				
Cr	Insurance contract liability- ECF		-	200	-	200
	Insurance contract liability - Risk Adj.			144		
	Insurance contract liability - RM/CM			156		300
Receipt of initial premium and recording of PV expected cash flows plus risk adjustment and residual margin or composite margin						
Dr	Insurance contract liability-acqn cost offset	180				
Cr	Cash			180		
Payment of incremental acquisition costs						
Dr	Expenses P&L	36				
Cr	Cash			36		
Payment of non incremental acquisition costs						

Balance sheet at 1 Jan

Modified Approach

Assets	
Cash	-116.0
	-116.0
Liabilities and equity	
Net pre-claims liability	-80.0
Net income for the year	-36.0
	-116.0

Building Block Approach

Assets		
Cash	-116.0	
	-116.0	
Liabilities and equity		
Insurance contracts liability-ECF	-380.0	-380.0
Insurance contracts liability-Risk Adju	144.0	
Insurance contracts liability-RM/CM	156.0	300
Net income for the year	-36.0	-36.0
	-116.0	-116.0

Receivable for expected future cash in flows of 1,100 is offset against the same amount for the pre-claims liability

Journal entries at 30 June

			Dr	Cr
	Dr	Cash	500	
	Cr	Pre-claims liability		500
		Receipt of premiums for Feb-June		
	Dr	Pre-claims liability	600	
	Cr	Premium revenue P&L		600
		Recognition of premium revenue for first 6 months		
	Dr	Amortisation of incremental acquisition costs P&L	90	
	Cr	Pre-claims liability (Acquisition cost offset)		90
		Amortisation of incremental acq. Costs		
	Dr	Claims and benefits expenses - P&L	360	
	Cr	Claims liability		360
		Establishment of claim liability under building blocks for post-claims period		
	Dr	Claims and benefits expenses - P&L	72	
IASB only	Cr	Claims liability - risk adjustment		72
		Establishment of risk adjustment for post-claims period		

			Dr	Cr
	Dr	Cash	500	
	Cr	Insurance contract liability		500
		Receipt of premiums for Feb-June		
	Dr	Insurance contract liability-amort of RM	78	
IASB only	Cr	Risidual Margin - P&L		78
		Amortization of Residual Margin		
	Dr	Insurance contract liability-amort of CM	92	
FASB only	Cr	Composite Margin - P&L		92
		Amortization of Composite Margin		

Composite margin				*300*
(premiums received+claims paid)	*600*	*0*	*600*	
(expected cash inflows + expected cash outflc	*1,200*	*750*	*1,950*	
				31%
Current year amortization of composite margir				*92*
Residual margin				*156*
Passage of time				*50%*
Current year amortization of residual margir				*78*

Balance sheet at 30 June

	IASB	FASB
Assets		
Cash	384	
	384	
Liabilities and equity		
Net pre-claims liability	-90	- 90
Claims liability - expected cash flow	360	360
Claims liability - risk adjustment	72	
Net income for the year	42	114
	384	384

	IASB	FASB
Assets		
Cash	384	
	384	
Liabilities and equity		
Insurance contract liability - expected cash flo	120	120
Insurance contract liability - risk adjustment	144	
Insurance contract liability-RM/CM	78	208
Net income for the year	42	56
	384	384

Change in assumptions at 30 June

Assume loss ratio increases
Assume risk adjustment is not impacted

Caculation of onerous contract test after change in assumption	
Discounted future cash flows:	
Expected premiums	1,200
Present value of future claims and expenses	- 816
Incremental acquisition costs	- 180
Net discounted future cash outflows	204
Risk adjustment	- 144
Present value of the fulfilment cash flows (PVFCF)	60
Therefore no additional loss to be recognisec	

Premiums		1,200		
Loss ratio	71%			
		850		
Discount rate	4%			
		34		
Composite margin recalculation				*300*
(premiums received+claims paid)	*600*	*0*	*600*	
(expected cash inflows + expected cash outflc	*1,200*	*850*	*2,050*	
				29%
Current year amortization of composite margir				*88*

Additional Journal entries at 30 June

			Dr	Cr
	Dr	Claims and benefits expenses - P&L	48	
	Cr	Claims liability		48
		Establishment of additional claim liability for change in assumptions		

			Dr	Cr
	Dr	Experience adjustment - P&L	96	
	Cr	Insurance contract liability		96
		Establishment of additional insurance contract liability for change in assumptions		
	Dr	Insurance contract liability-amort of CM	- 4	
FASB only	Cr	Composite Margin - P&L		- 4
		Amortisation of Composite Margin adjustment		

Balance sheet at 30 June - Adjusted

	IASB	FASB
Assets		
Cash	384	
	384	
Liabilities and equity		
Net pre-claims liability	-90	- 90
Claims liability - expected cash flow	408	408
Claims liability - risk adjustment	72	
Net income for the year	-6	66
	384	384

	IASB	FASB
Assets		
Cash	384	
	384	
Liabilities and equity		
Insurance contract liability - expected cash flo	216	216
Insurance contract liability - risk adjustment	144	
Insurance contract liability-RM/CM	78	212
Net income for the year	-54	- 44
	384	384

Journal entries at 31 Dec

			Dr	Cr
	Dr	Cash	600	
	Cr	Pre-claims liability		600
		Receipt of premiums for July-Dec		
	Dr	Pre-claims liability	600	
	Cr	Premium revenue P&L		600
		Recognition of premium revenue for second 6 months		
	Dr	Amortisation of incremental acquisition costs P&L	90	
	Cr	Pre-claims liability (Acquisition cost offset)		90
		Amortisation of incremental acq. Costs		
	Dr	Claims and benefits expenses - P&L	408	
	Cr	Claims liability		408
		Establishment of claim liability under building blocks for post-claims period		
	Dr	Claims and benefits expenses - P&L	72	
IASB only	Cr	Claims liability - risk adjustment		72
		Establishment of risk adjustment for post-claims perioc		

			Dr	Cr
	Dr	Cash	600	
	Cr	Insurance contract liability		600
		Receipt of premiums for July-Dec		
	Dr	Insurance contract liability-amort of RM	78	
IASB only	Cr	Residual Margin - P&L		78
		Amortisation of Residual Margin		
	Dr	Insurance contract liability-amort of CM	88	
FASB only	Cr	Composite Margin - P&L		88
		Amortisation of Composite Margin		

Composite margin				*300*
(premiums received+claims paid)	*1200*	*0*	*1,200*	
(expected cash inflows + expected cash outflc	*1200*	*850*	*2,050*	
				59%
Current year amortization of composite margir				*176*
Residual margin				*156*
Passage of time				*100%*
Current year amortization of residual margir				*156*

Balance sheet at 31 Dec

	IASB	FASB
Assets		
Cash	984	
	984	
Liabilities and equity		
Net pre-claims liability	0	-
Claims liability-ECF	816	816
Claims liability - risk adjustment	144	
Net income for the year	24	168
	984	984

	IASB	FASB
Assets		
Cash	984	
	984	
Liabilities and equity		
Insurance contract liability-ECF	816	816
Insurance contract liability - risk adjustment	144	
Insurance contract liability-RM/CM	0	124
Net income for the year	24	44
	984	984