Staff Paper

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Project	**Insurance Contracts**
Topic	**Short Duration Contracts: Modified Approach**

This paper has been reposted on 26 April with some corrections. The changes are shown in mark-up. Board members have been provided with an errata document summarising the changes. That document is also available for observers.

Purpose of this paper

1. This paper discusses:
   - (a) Comparison of the modified approach to current GAAP
   - (b) Recommended changes to the measurement model for insurance contracts measured under the modified approach.
2. This paper asks the Boards to decide on:
   - (a) Eligibility requirements for the modified approach
   - (b) The appropriate measurement for contracts using the modified approach during the preclaims period
   - (c) The criteria for triggering and performing an onerous contract test
   - (d) Whether to permit or require the modified approach
3. This paper does not discuss presentation for the modified approach. This will be discussed with the overall presentation.
4. This paper only addresses the preclaims period accounting for short duration contracts that are eligible for the modified approach and does not discuss the accounting in the claims period for those contracts. The accounting during the claims period for short duration contracts in which the time value of money component may be immaterial will be discussed in a future meeting.

Structure of this paper

5. The remainder of this paper is structured as follows:

    (a) Staff recommendations summary

    (b) Comparison of the modified approach to current GAAP (unearned premium approach), the building block approach, and the recent decisions in the revenue recognition project

    (c) Relevant questions from the ED/DP

    (d) Feedback received on the ED/DP

    (e) Staff analysis

        (i) Eligibility requirements

        (ii) Pre-claims period accounting

            (a) Acquisition costs

            (b) Discounting and accretion

            (c) Revenue recognition pattern

            (d) Onerous contract test

        (iii) Permitting vs. requiring the modified approach

Staff recommendations summary

6. The staff recommend the following:

    (a) An insurer is permitted, but not required to apply the modified approach to contracts that meet all of the following requirements:

        (i) The contract does not include a significant financing element.

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

    (b) A contract does not include a significant financing element if the following criteria are met:

(i) The time between the receipt of premium and the ~~start~~ provision of ~~the~~ coverage ~~period~~ is insignificant,

(ii) The amount of premium charged is not substantially different if the policyholder paid at the beginning of the coverage period,

(c) As a practical expedient, a contract is not considered to include~~It is assumed that there is not~~ a significant financing element if the coverage period is one year or less.

(d) For insurance contracts to which the modified approach is applied, an insurer shall measure its pre-claims obligation at initial recognition as:

(i) The premium, if any, received at initial recognition, plus the undiscounted value of expected future premiums, if any, that are within the boundary of the existing contract; less

(ii) The acquisition costs as tentatively decided by the FASB and IASB respective boards (additional alternatives are provided in the analysis below).

(e) Subsequently, the insurer shall reduce the preclaims obligation to reflect satisfaction of the performance obligation to provide coverage. The performance obligation is satisfied as the insurer provides insurance coverage as follows:

(i) On the basis of time, but

(ii) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

(f) An insurer should assess if the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation if the following factors indicate that a contract may be onerous:

(i) the combined loss ratio exceeds 100%,

(ii) there is a significant increase in the severity or frequency of claims, or

(iii) there is a change in the characteristics of the risk profile.

> If, on that assessment, the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation, the insurer shall recognise an additional liability for that excess.

Comparison of the modified approach to current GAAP

7. The modified approach is akin to the accounting model for short-duration insurance contracts in Topic 944 of the *FASB Accounting Standards Codification*™ (previously FASB Statement No. 60 *Accounting and Reporting by Insurance Enterprises*) and is similar, if not identical, to the model used in several countries for short-duration insurance contracts. Examples of short-duration contracts include most property and liability insurance contracts and particular accident and health insurance contracts. Two key aspects of the short-duration insurance contract model under current GAAP are (a) the premium is generally recognized on a straight-line basis over the coverage period of the contract or in proportion to the amount of insurance protection if different and (b) a claims liability is measured on an incurred basis (that is, a liability is only recognized when an insured event has occurred). This memo will discuss aspect (a) while a future memo will address the claims liability noted in aspect (b) for short duration contracts in which the time value of money may be immaterial.

8. The link between revenue recognition and claims recognition is the unearned premium in the pre-claims period. The implicit assumption underlying current GAAP is that the unearned premium represents the stand-ready obligation of the insurance entity. Therefore, the staff believe that it is appropriate to analyze the accounting for the pre-claims period (modified approach) in the context of some of the recent decisions reached by the boards in the revenue recognition project where appropriate.

9. The following table summarizes the differences between the unearned premium approach under current GAAP, the modified (premium allocation) approach as proposed in the ED/DP, the building block approach, the staff's recommendations in this memo, and the recent decisions reached in the revenue recognition project:

	Current GAAP (unearned premium) Approach	Proposed Modified Measurement Approach	Building Block Approach (Margin model: no revenue)	Staff Recommendation	Revenue Recognition Project
Eligibility for modified measurement approach (discussed in paragraphs 23-66 of this memo)	Application of local GAAP principles. Typically contracts for a fixed period of short duration that enables the insurer to cancel the contract or adjust the provisions of the contract at the end of the contract period.	Short-duration contracts with a coverage period of approximately 12 months or less. The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows after unbundling any embedded derivatives	N/A	An insurer is permitted, but not required to apply the modified approach to contracts that meet all of the following requirements: (a) The contract does not include a significant financing element. (b) The contract does not contain embedded options or other derivatives that significantly affect the variability of the cash flows, after unbundling any embedded derivatives. A contract does not include a significant financing element if the following criteria are met: (a) The time between the receipt of premium and the start of the coverage period is insignificant, (b) The amount of premium charged is not substantially different if the policyholder paid at the beginning of the coverage period, (c) The coverage period is one year or less.	N/A – however, time value of money not required for contracts less than one year as practical expedient
Insurance liability in the preclaims period at initial recognition. See next row for revenue recognition. (discussed in paragraphs 67-105 of this memo)	Unearned premium reserve equivalent to premiums charged for the unexpired coverage period	Pre-claims obligation - Premium, if any, received at initial recognition, plus the expected present value of future premiums, if any	Expected present value of the mean of the fulfilment cash flows.	For insurance contracts to which the modified approach is applied, an insurer shall measure its pre-claims obligation at initial recognition as: (a) The premium, if any, received at initial recognition, plus the undiscounted value of expected future premiums, if any, that are within the boundary of the existing contract; less (b) The acquisition costs as tentatively decided by the FASB and IASB respective boards (alternatives are provided in the analysis below).	Amount of consideration allocated to performance obligation. Reflect time value of money when a significant financing element is present. Significant financing element considerations include (a) Amount of consideration would differ if customer paid in cash at the time of transfer of goods or service (b) Significant timing difference between delivery and payment (c) Explicit or implicit interest rate

	Current GAAP (unearned premium) Approach	Proposed Modified Measurement Approach	Building Block Approach (Margin model: no revenue)	Staff Recommendation	Revenue Recognition Project
Revenue recognition during the preclaims period (discussed in paragraphs 106-111 of this memo)	Recognized in proportion to the protection provided	Same as current GAAP	**Dual margin**: Recognize changes in risk adjustment to profit and loss based on measurement; recognize residual margin over coverage period **Single margin**: Recognize composite margin over coverage and claims period	Subsequently, the insurer shall reduce the preclaims obligation to reflect satisfaction of the performance obligation to provide coverage. The performance obligation is satisfied as the insurer provides insurance coverage as follows: (a) On the basis of time, but (b) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.	For services – as performance obligation is satisfied (similar to Insurance) For goods – when customer obtains control of good
Onerous contract test (discussed in paragraphs 112-139 of this memo)	Depending on the GAAP principles applied, contracts tested each period for premium deficiency by comparing the sum of undiscounted losses, loss expenses, and acquisition costs to the remaining unearned premiums. Investment income may be considered.	Contracts tested each period for premium deficiency by comparing the amount determined using the building block approach to the remaining unearned premiums.	Not required.	An insurer should assess if the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation if the following factors indicate that a contract may be onerous: (a) the combined loss ratio exceeds 100%, there is a significant increase in (b) the severity or frequency of claims, or (c) there is a change in the characteristics of the risk profile. If, on that assessment, the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation, the insurer shall recognise an additional liability for that excess.	Costs directly related to satisfying remaining performance obligations exceed the amount of the transaction price allocated to those performance obligations. The test is performed at the contract level

10. Some respondents commented that the full building-block approach overcomplicates the accounting required to properly reflect the economics of some short duration contracts with coverage periods outside of the one-year requirement of the ED.

11. Many respondents to the ED did not believe the modified approach was a simplification of the full model. For example, respondents commented that features such as interest accretion in the pre-claims period and discounting the expected future premiums complicate the model with immaterial change and will make it difficult for users to understand an insurer's operations. In addition, the inclusion of a risk adjustment in the onerous contract test under the IASB's two margin approach is seen as complicating the model.

Relevant Questions from the ED/DP

12. Question 18 of the FASB's DP asked respondents:

> Do you think that all insurance contracts should be recognized and measured using one approach or that certain insurance contracts should be recognized and measured using an alternative approach (for example the modified approach)? Why or why not?

13. Question 20 of the FASB's DP asked respondents:

> Do both the building-block approach and the modified approach (with the latter approach applied only to certain short-duration contracts) produce relevant and decision-useful information? Why or why not?

14. Question 21 of the FASB's DP asked respondents:

> How should the scope of insurance products for each approach be defined (for example, duration of coverage period, duration of claims payment period, or type of insurance)?

15. Question 22 of the FASB's DP asked respondents:

> Are there specific types of insurance contracts for which the approaches would not provide decision-useful information?

16. Question 8(a) of the IASB's ED asked respondents:

> Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

17. Question 8(b) of the IASB's ED asked respondents:

> Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

Feedback received on the ED/DP

18. A high level summary of the feedback received is provided here. Specific feedback on each topic is included in the respective areas below.

19. Respondents were primarily concerned with the cost-benefits of the modified approach. It was unclear how a significant benefit is derived if preparers using the modified approach are required to calculate a risk adjustment or the impact of time value of money on their pre-claims liabilities.

20. Some non-life preparers did not perceive an improvement to current GAAP was necessary in their respective jurisdictions. They argued the proposals would require significant education and communication efforts to their employees and investors.

21. Many respondents acknowledged the desirability of a consistent set of global standards for insurance accounting. They recognized a properly designed simplified approach would reduce implementation costs while maintaining relative consistency with the full building-block model required of other contracts.

22. Based on feedback received through comment letters and other outreach communications the staff prepared an analysis for the boards' consideration on the following topics:

    (a) Eligibility requirements for the modified approach

    (b) Preclaims period measurement

        (i) Acquisition costs

(ii) Discounting and accretion

(iii) Revenue recognition pattern

(iv) Onerous contract test

(c) Permitting vs. requiring the modified approach

Staff Analysis

Eligibility requirements

Proposed requirements

23. Paragraph 55-60 of the IASB ED describe a modified measurement approach that would apply to insurance contracts that meet both of the following conditions:

    (a) The coverage period of the insurance contracts 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 […].

24. Paragraph BC146 in the IASB's ED discusses the IASB's view that when the pre-claims period is approximately one year or less and provided that the contract contains no significant embedded derivatives, the unearned premium is a reasonable approximation of the present value of the fulfillment cash flows and the residual margin (and achieves a similar result at a lower cost).

25. Paragraph BC145 in the IASB's ED states that the modified approach is consistent with the customer consideration approach proposed in the exposure draft *Revenue from Contracts with Customers*.

26. Paragraph 105 of the FASB's DP states that the FASB Board had not determined the extent to which, or the conditions under which, a modified approach would apply.

Feedback received about eligibility

27. Many respondents, in particular property / casualty and health preparers, expressed opposition to the one-year eligibility restriction for the modified

approach. This opposition primarily stems from the fact that under current GAAP in many jurisdictions, the contracts these particular entities write are considered short-duration contracts and do not always fall within what some perceive to be a bright line rule of one year. These respondents believe that the determination of short-duration contracts under current GAAP (for example, U.S., U.K or Canadian) is well understood and used in many jurisdictions and, therefore, an approach similar to these should be used in the final standard. Additionally, they are concerned the proposal will result in different accounting for similar products with different terms. For example, some non-life contracts may have durations longer than one year but share similar economic characteristics with one year contracts.

28. Some respondents also questioned how the one-year eligibility requirement would affect reinsurance contracts that reinsure one-year policies written during that year. They believe that reinsurance contracts should be accounted for using the same approach as the underlying insurance contract. The staff decided to factor this into the analysis of how duration criteria are defined. The discussion between an option or requirement to treat reinsurance contract assets based on their underlying contract will be considered in the reinsurance analysis memo.

29. Some specific reinsurance concerns included:

    (a) Proportional reinsurance contracts that cover a one-year period on a risk attaching basis - the length of coverage for the underlying contracts is 12 months but since the reinsurance attaches as the direct insurer becomes exposed to risk over a 12 month period the total coverage period of the reinsurance contract is 24 months.

    (b) Yearly renewable term reinsurance on life insurance policies is often based on a twelve month contract but is typically renewed and therefore is priced and functions as a long-duration contract.

30. If the proposed one-year coverage period is retained, respondents requested clarification of what “approximately one year” means.

31. Respondents offered several suggestions for establishing eligibility criteria for the modified approach. Those suggestions included basing the criteria on the following:

(a) investment income potential over the coverage period is not a significant portion of the business model

(b) the period of time between premium receipt and date of loss is not significant

(c) the contract is primarily based on risk protection and therefore focuses on underwriting results as opposed to investment management

Staff analysis

32. The staff believe the implication of applying the building block approach versus the modified approach is to force entities to use a measurement model that is more complex in its application to arrive at a result that is not significantly different than if the entity used the modified approach. In developing accounting standards there should be a balance between providing useful information to the users of financial statements with the costs of supplying such information. Keeping in mind the comments received from respondents about "over-engineering" of the modified approach and the notion that respondents believe contracts that would use the modified approach are fundamentally different from those that would not, the staff believe the modified approach should be:

    (a) Simplified from what was exposed in the ED, and

    (b) Applicable to contracts where the use of a modified approach would not be significantly different from the full building block approach.

33. Many of the suggestions offered above were based on the notion that the business model for shorter duration (non-life type) contracts is fundamentally different than longer duration (life type) contracts. Some respondents referred to this business model as the continuous risk re-underwriting business model and identified particular characteristics that differentiate between shorter and longer duration contracts.

34. The staff examined these characteristics to determine whether there were unique features that could be used to establish eligibility criteria for the modified approach. For simplicity and ease of reading, the staff have referred to the contracts discussed as "non-life" and "life" as this is how they are typically thought of by many people. The characteristics examined were as follows:

Characteristic	Non-life	Life
Coverage duration	Shorter-duration	Longer-duration
Type of risk	Can cover various commercial and personal losses with relatively short durations (See Appendix A for examples)	Cover benefits paid to individual policyholders over time with significant time from inception of contract to payment of benefit
Primary performance indicators and metrics managed	Combined loss ratios, claims development	Margin analysis for investments, mortality, and morbidity and actual to expected experience measures
- Investment results	- Secondary consideration	- Primary consideration
- Matching of asset and liability cash flows	- Not the primary focus as shorter duration assets are required to fund liabilities that could become due immediately. Primary focus is underwriting.	- Primary focus of the model because of the need to fund long duration liabilities over time.
- Primary risk exposure	- Frequency and severity of claims; increased uncertainty of cash outflows	- Investment, mortality and morbidity experience
- Amount of insurance risk	- Variable up to policy limits	- Amount of insurance coverage specified in contract
- Premiums	- Typically single and fixed; profitability issues typically addressed through pricing of future contracts; Insurance risks re-underwritten and re-priced annually or more frequently; Contracts cancelable during coverage period with mandatory pro-rata refunds	- Discretionary premiums may continue over coverage period; Risks not re-underwritten or re-priced annually or more frequently

Coverage duration

35. Insurance contracts are often classified by the duration of coverage under current GAAP. Therefore, the staff evaluated whether the duration of the insurance coverage could be the criterion to use the modified approach.

36. Some respondents suggested using the current US GAAP guidance to define duration and thus the contracts eligible for the modified approach. Respondents commented that the concepts in the definition are commonly understood in practice and this approach would properly classify many contracts based on their underlying economics of focusing on underwriting margins as opposed to long-term asset and liability management.

37. Paragraph 944-20-15-7 of the FASB's Accounting Standards Codification states:

"…insurance contracts, for purposes of this Subtopic, shall be classified as short-duration contracts or long-duration contracts depending on whether the contracts are expected to remain in force for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are as follows for a short-duration contract:

> *(i) The contract provides insurance protection for a fixed period of short duration.*
>
> (ii) *The contract enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided."*

38. While using the current definition of short duration in US GAAP may seem like a reasonable answer, others commented that there are issues with the US GAAP definition. The first criterion of a short duration contract is a contract that provides insurance protection for a short-duration. Many view this as circular and not particularly helpful in assessing whether a contract's duration should be deemed short relative to another. The second criterion of a short duration contract is that the contract enables the insurer to cancel the contract or adjust the provisions of the contract at the end of any contract period. This provision is implicit in any contractual arrangement. The staff agreed with these concerns and

therefore concluded that using the current definition of short duration provided under US GAAP would not be a viable alternative.

39. The staff then examined if coverage duration alone could be a viable option for determining whether a contract could use the modified approach. In general, personal insurance is typically one year, however commercial insurance can vary. The staff included examples of non-life contracts that may have durations longer than one year but still considered by some as short duration in Appendix A.

40. When examining the examples provided in Appendix A, it becomes clear that numerous issues may arise when the duration of coverage is used as the eligibility criterion including:

   (a) By using what some perceive to be a bright-line duration of coverage, identical products in terms of risks and exposures, with different durations, could be accounted for and presented differently

   (b) Portfolios would need to be re-defined such that there are not contracts within a portfolio that are accounted for using two different approaches

   (c) Bright line tests could create an opportunity to engage in accounting arbitrage

   (d) Should the boards adopt the presentation approaches proposed in the ED, useful information could be made less transparent for contracts that do not meet the duration of coverage criterion.

41. Given these potential issues, the staff concluded that the use of coverage duration alone would not be sufficient to determine a contract's eligibility for using the modified approach.

Type of risk

42. Several suggestions described a concept based on the type of insurance risk. This approach was likely suggested because many insurance contracts are classified by the types of risk(s) covered. In addition, when examining the difference between non-life and life businesses as depicted above, the staff thought this could be a possible solution. Consequently, the staff began the analysis by compiling a list of insurance contracts and the risks covered by those contracts. Appendix B includes this listing of examples of some contracts and the types of risks covered.

43. Although Appendix B is not meant to be an exhaustive list, this exercise led the staff to conclude that it would be cumbersome, if not impossible, to create and maintain a list of insurance contracts to compare by type of risk to determine if the contract is eligible for the modified approach.

44. The staff then considered whether only contracts with particular risks could be included to determine eligibility for the modified approach. However, the staff concluded this approach could result in accounting arbitrage and would potentially need to be re-visited in the future as new products are developed.

45. Finally, the staff considered whether contracts that cover particular risks could be excluded to determine eligibility for the modified approach. For example, excluding mortality risk would prohibit the modified approach for life insurance contracts. While this may appear to be a more sound approach than an exhaustive listing of contracts or including contracts with particular risk coverage, the staff concluded this was not a viable option because it is conceivable that a contract could be developed that contained a risk deemed to be excluded yet be economically similar to other contracts included.

46. Furthermore, the staff believe that any approach that focuses on a listing of contracts that could be in or out of the modified approach is not consistent with the development of a principles based standard on a global level and thus would be inappropriate.

Primary performance indicators and metrics managed

47. Based on the analysis above, the staff concluded that each of the criteria examined was flawed and insufficient on its own for consideration as the final eligibility criterion. However, the staff believe that if combined, some of the elements presented above could appropriately identify insurance contracts that should be accounted for under a modified approach. When combined these elements provide the reasons why non-life and life contracts are fundamentally different.

48. The staff began further analysis by examining why the primary performance indicators for non-life and life contracts are different. Non-life management focuses on combined loss ratios and claims development while life management focuses on the margin analysis for investments, mortality, morbidity and actual to expected experience.

49. The staff concluded that the performance metrics for non-life contracts are different because the risks covered by these contracts are fundamentally different from risks covered by life contracts. For non-life contracts, the frequency and severity of the insured events affect the estimation of the expected cash outflows in the building block model in a different way because of the increased uncertainty due to the nature of the risks covered. For example, the primary source of uncertainty for a life insurance contract is the timing of the policyholder's death whereas, for instance, the primary uncertainties of a property catastrophe contract involve the timing of the event (including if the event happens) and the ultimate amount of the claim payment. As a result, non-life contracts tend to be of a shorter duration than life contracts given the uncertainty of the outcome.

50. This shorter duration and difference in frequency and severity, in turn, translates into a different approach for managing non-life contracts. For these contracts, the focus is primarily one of underwriting instead of investment management because of the relatively short-term nature of the coverage periods involved. The shorter duration, by definition, means there is not time for investment returns to mature to fund liabilities or make up for potential losses due to underwriting. This difference was noted by several commentators to the ED. They commented that while asset and liability management is important, it is not the primary concern of non-life insurers. While the non-life insurer attempts to match assets and liabilities, the uncertainty in the amount and timing of the payout effectively forces the insurer to invest in shorter term, highly liquid assets, in order to have the ability to fund liabilities that could come due immediately.

51. Rather than accepting premiums over time to invest for the long term, as is the case for life insurance, the entity is provided with a premium to stand ready to perform on an obligation if, and when, the insured event occurs. The entity is released from that obligation to stand ready, over the coverage period of the contract through the passage of time or in proportion to the amount of insurance protection provided if different and "earns" the premium. This is different from life insurance where the performance of the entity is primarily a function of the investment strategy.

52. This is also consistent with why combined loss ratios and claims development are considered important performance metrics by non-life insurance entities while investment management is secondary. The compensation to the contract holder is based on the amount of the incurred insured loss, which is variable up to the amount of the policy limit versus a specified amount in the contract. Users look to the combined loss ratio to determine whether the premium charged will cover the losses and the loss adjustment expenses. Users also look at the loss development tables to determine trends and how well the company initially estimated its reserve for each accident year and subsequent adjustments to the ultimate losses expected.

53. These differences could lead to the conclusion that the preclaims period is more akin to a revenue recognition model than a liability measurement model. This conclusion is consistent with the board's thinking as expressed in paragraph BC 145 of the basis for conclusions to the ED that states the modified approach is consistent with the customer consideration approach proposed in the exposure draft *Revenue from Contracts with Customers.* The staff agrees with this rationale but believes it would apply to more contracts than just those that are approximately one year or less because, as discussed above, there are contracts that are greater than one year that exhibit the same characteristics.

Applicable elements of revenue recognition

54. When developing the modified approach, it is clear from paragraph BC 146 that the board believed the unearned premium was a reasonable approximation of the present value of the fulfillment cash flows and residual margin during the preclaims period. It is also clear that the board intended to provide an approach that achieved a similar result to the building block approach at a lower cost. Therefore, the staff believes the objective of making changes to the modified approach should be two-fold:

    (a) Simplify the modified approach to address the concerns of "over-engineering" to make it truly cost beneficial, while

    (b) Capturing all contracts that exhibit the same characteristics for consistency of application.

55. Two of the primary complaints of "over-engineering" stemmed from:

(a) Discounting of future premiums and subsequent accretion and unwind of the discount, and

(b) Including a risk adjustment in the onerous contract test.

56. If it is true that non-life contracts are different than life contracts as described above and that the preclaims period is more akin to a revenue recognition model, the staff believe that the eligibility criteria should capture contracts that have the same characteristics while also considering the applicable elements of the revenue recognition model to determine what differences with respect to eligibility, if any, should be applied to insurance.

Performance obligation

57. Revenue recognition defines a performance obligation as:

(a) Promise in a contract with a customer to transfer a good or service to the customer. Performance obligations include promises that are implied by an entity's business practices, published policies, or specific statements if those promises create a valid expectation of the customer that performance of the entity will occur.

58. The staff believe, as described above, these particular contracts exhibit characteristics that are more akin to a stand ready obligation to perform when an insured event happens by providing insurance coverage and do not believe this is inconsistent with the revenue recognition definition.

Time value of money

59. Revenue recognition addresses the time value of money in the following manner:

(a) An entity should adjust the promised amount of consideration to reflect the time value of money if the contract includes a financing component that is significant to that contract. In assessing whether a contract has a significant financing component, an entity should consider various factors, including the following:

(i) Whether the amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer of the goods or service

(ii) Whether there is a significant timing difference between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services

(iii) Whether the interest rate that is explicit or implicit within the contract is significant.

60. The staff believe that the first criterion in (a)(i) of the preceding paragraph is relevant to insurance accounting and should be contemplated in the eligibility requirements for the modified approach. The criterion could be significant if an insurer charged a policyholder a fee for paying premium over time as opposed to paying the premium up front. This fee could amount to a significant implicit interest that could affect the pattern of revenue recognition during the preclaims period and the ultimate amount of the preclaims obligation rendering the modified approach as an insufficient proxy for what would be calculated under the building block approach. Although the concept is applicable, the wording will need to be modified to conform to insurance accounting.

61. The staff believe that the second criterion in (a)(ii) above is not relevant to insurance accounting and should not be contemplated in the eligibility requirements for the modified approach. This criterion primarily relates to providing a financing element after the good has already been delivered or the service already performed. In the case of insurance, if the policyholder does not pay their premium, the policy will lapse and no coverage is provided. The staff do believe this criterion could be reworked to incorporate a timing element for insurance by describing the timing difference between receipt of initial premium and the coverage period provided. This timing difference could be an indicator that the insurance contract includes a significant financing element.

62. The staff believe that the final criterion is captured within the first two criterions given that the implicit interest is a function of time and amount and therefore we believe the final criterion is redundant.

Practical expedient

63. The recent decisions for revenue recognition provide for a practical expedient when the contract is less than one year. The main advantage provided for exempting an entity from accounting for any time value of money effects arising

from short-term contracts was that it would simplify compliance with the revenue standard. This is because an entity would not be required to:

(a) conclude whether those contracts contain the attributes of a significant financing component; or

(b) determine the interest rate that is implicit within those contracts.

In addition, it was not expected that the time value of money implicit in most short-term contracts would be significant.

64. The staff agrees with this rationale and does not find a compelling reason to treat contracts of less than one year differently for insurance.

Embedded Options

65. The board concluded as part of the ED that contracts that contain embedded options or other derivatives that significantly affect the variability of the cash flows could not apply the modified approach. This is because the simplification of the measurement assumes (as expressed in paragraph BC 146 of the Basis for Conclusions) that the unearned premium serves as a reasonable approximation of the present value of the fulfillment cash flows and the residual margin. If it were to be assumed the unearned premium would serve as a proxy for measure in any simplified model, then the staff would agree that the contract should not contain such options. Therefore, the staff recommend that the eligibility criteria should maintain this restriction.

Staff recommendation

66. The modified approach can be applied to insurance contracts that meet all of the following criteria:

(a) The contract does not include a significant financing element.

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

(c) A contract does not include a significant financing element if the following criteria are met:

(i) The time between the receipt of premium and the provision~~start~~ of ~~the~~ coverage ~~period~~ is insignificant,

(ii) The amount of premium charged is not substantially different if the policyholder paid at the beginning of the coverage period,

(d) As a practical expedient, a contract is not considered to include a significant financing element if ~~T~~the coverage period is one year or less.

Question 1 – Modified approach: Eligibility
Do the Boards agree with the staff recommendation that the modified approach can be applied to insurance contracts that meet all of the following criteria? (a) The contract does not include a significant financing element. (b) The contract does not contain embedded options or other derivatives that significantly affect the variability of the cash flows, after unbundling any embedded derivatives.

Preclaims Period Measurement

Acquisition costs

67. Paragraph 56 of the IASB's ED proposes that the pre-claims obligation is measured as the premium received at initial recognition plus the expected present value of future premiums, if any that are within the boundary of the existing contract; less the incremental acquisition costs.

68. Paragraph 75 of the ED proposes that for contracts measured using the modified approach, an insurer disaggregates in the statement of comprehensive income or in the notes the amortization of incremental acquisition costs and premium revenue, determined as the gross release of the pre-claims obligation, grossed-up for the amortization of incremental acquisition costs.

69. Paragraph 106 of the FASB's DP indicates that the FASB had not determined how to treat incremental acquisition costs and whether it would reduce the pre-claims liability.

Related tentative decisions

70. At the February 1, 2011 meeting, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts.

71. During the March 2, 2011 meeting, the IASB tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the costs that the insurer will incur in acquiring the portfolio, including costs that relate directly to the acquisition of the portfolio, such as commissions.

72. Also during that meeting, the FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to:

   (a) costs related to successful acquisition efforts; and

   (b) direct costs that are related to the acquisition of a portfolio of contracts.

73. As part of revenue recognition, the boards have tentatively decided that the costs of obtaining a contract should be accounted for in the following manner:

   (a) An entity should recognize an asset for the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained.

   (b) An asset recognized for the costs of obtaining a contract should be presented separately on the statement of financial position and subsequently measured on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.

Feedback received

74. A few respondents suggested that insurers be permitted to expense some acquisition costs as incurred, rather than including those costs in the expected cash flows. For insurers that write particular lines of business, the majority of their acquisition costs are comprised of commissions and premium taxes and the policy period may be short (6 to 12 months). The system and other costs to determine the expenses related to other acquisition related activities that would meet the criteria to be included in the cash flows, such as underwriting and policy issuance exceed the benefit.

75. A few respondents also suggested that acquisition costs be presented separately instead of netting those costs against the expected cash flows.

Staff analysis

76. The staff considered whether insurers should be required to reduce the pre-claims liability for:

    (a) All the costs that the insurer will incur in acquiring the portfolio in accordance with the tentative decisions made by the IASB and the FASB or

    (b) Only some of the acquisition costs that would qualify to be included in the amount that would reduce the pre-claims liability.

77. The staff believes there are three alternatives for proceeding with the accounting for acquisition costs under the modified approach:

    (a) Alternative 1 – account for acquisition costs as if under the building block approach

    (b) Alternative 2 – account for acquisition costs as if under the revenue recognition approach

    (c) Alternative 3 – permit or require entities to expense particular acquisition costs

78. Some would argue that acquisition costs should be accounted for consistently regardless of what model the contract falls under. Therefore, they see no compelling reason to apply different accounting for acquisition costs under a modified approach. The facts and circumstances that generated the acquisition costs are not different and should not be accounted for differently. Furthermore, accounting for acquisition costs differently is effectively creating an additional complexity that is unwarranted and would need to be reconciled through disclosure.

79. Some staff believe that because the revenue recognition model is applicable to the preclaims period, that all aspects of the revenue recognition model should be adopted and therefore acquisition costs should be accounted for under revenue recognition and see no compelling argument to account for them differently. Other staff would argue that the boards decided that under the revenue recognition

model that acquisition costs were determined to be an asset whereas under insurance, the costs were determined to be part of the liability measurement. Additionally, the revenue recognition model includes the notion of recoverability, which is only applicable to assets.

80. In practice, several entities that apply a short-duration model today capitalize external incremental acquisition costs and expense all internal incremental acquisition costs as incurred. Tracking external incremental acquisition costs, which are the most significant component of acquisition costs for the majority of the types of contracts that would apply the modified approach, is straightforward. However, the costs to perform regular cost studies and to modify systems to track internal incremental acquisition costs that will reverse over a short coverage period, does not appear to outweigh the benefits.

81. Based on the factors above some staff recommend that insurers that account for their insurance contracts under the modified approach have the option of expensing some internal incremental acquisition costs that otherwise meet the criteria to reduce the pre-claims liability in accordance with the tentative decisions made by the IASB and the FASB and be required to disclose which acquisition costs are included in the pre-claims liability. The Staff will address disclosures in a future meeting.

82. Other staff agree that for cost considerations an entity should not have to “defer” internal costs that are not currently tracked. However, for comparability reasons, those staff do not agree with providing entities with an option for expensing. Therefore, believe that if the boards allow entities to account for acquisition costs differently than the building blocks model it should be a requirement not an option.

83. In regards to presentation, the boards previously decided that deferring acquisition costs as an asset would report an asset that either (a) does not exist (if the insurer recovers acquisition costs from cash already received) or (b) relates to future cash flows. As such, the boards tentatively decided to include acquisition costs in the present value of expected cash flows. Although the modified approach does not explicitly measure the fulfillment cash flows in a contract, it is considered a reasonable approximation to such a measurement for many short-duration

contracts. Including the acquisition costs that would otherwise qualify to be included as part of the expected cash flow as a reduction of the pre-claims obligation is consistent with the building block approach.

84. The staff will address presentation of acquisition costs in the statement of comprehensive income in a future memo.

Staff recommendation

Question 2 – Modified approach: acquisition costs
Do the Boards agree with the staff recommendation to: (a) reconfirm that an insurer should deduct from the preclaims obligation measurement the amount of acquisition costs as tentatively decided by the FASB and IASB respective boards? Which alternative do the boards support? (a) account for acquisition costs in accordance with the building blocks approach? (b) account for acquisition costs in accordance with revenue recognition? (c) permit some internal incremental acquisition costs to be expensed as incurred rather than being included in the determination of the pre-claims obligation? (d) require some internal incremental acquisition costs to be expensed as incurred rather than being included in the determination of the pre-claims obligation?

Time value of money – pre-claims liability

85. Paragraph 56 of the IASB's ED states that the pre-claims obligation is measured as the premium received at initial recognition plus the expected present value of future premiums, if any, that are within the boundary of the existing contract; less the incremental acquisition costs.

86. Paragraph 59 of the IASB's ED indicates that an insurer shall accrete interest on the carrying amount of the insurance contract.

87. Paragraph 106 of the FASB's DP indicates that the Board had not determined whether interest would be accreted on the carrying amount of the pre-claims liability.

88. 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.

Related tentative decisions

89. At the February 17, 2011 meeting, the Boards tentatively approved a set of axioms. These included that money has a time value, and an entity more faithfully represents its position when it measures its liabilities in a way that includes the time value of money.

90. At the March 3, 2011 meeting, the Boards tentatively decided to require discounting for all non-life claims. However, the Boards agreed that discounting of insurance liabilities should not be required when the effect of discounting would be immaterial.

91. In the revenue recognition project, the Boards tentatively decided that an entity should adjust the promised amount of consideration to reflect the time value of money if the contract includes a financing component that is significant to that contract. In assessing whether a contract has a significant financing component, an entity should consider various factors, including the following:

    (a) Whether the amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer of the goods or service

    (b) Whether there is a significant timing difference between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services

    (c) Whether the interest rate that is explicit or implicit within the contract is significant.

92. The Boards also tentatively decided in the revenue recognition project that, as a practical expedient, an entity should not be required to assess whether a contract has a significant financing component if the period between payment by the

customer and the transfer of the promised goods or services to the customer is one year or less.

93. In the leases project, the boards tentatively decided to provide an exception that short-term leases do not require balance sheet recognition. The definition of a short-term lease is one that at the date of commencement of the lease has a maximum possible term, including any options to renew, of 12 months or less.

Feedback received

94. Some respondents believe that features such as discounting the expected future premiums and interest accretion in the pre-claims period complicate the model with immaterial change, for little benefit, and will make it difficult for users to understand an insurer's operations.

95. Respondents often compared the premium allocation approach proposed in the DP/ED to the unearned premium reserve approach that is used under current GAAP in many jurisdictions. The discounting for premiums was viewed as the most significant departure from the current approach and respondents felt the costs to upgrade their systems were not justified.

Staff analysis

96. The staff considered whether insurers should measure their pre-claims obligation at initial recognition:

    (a) Considering the time value of money and therefore discounting the future premiums and accreting interest, or

    (b) As the nominal value of future premiums

97. If the time value of money were not considered in determining the expected present value of future premiums, it would represent a departure from the underlying building-block approach.

98. However, discounting future premiums would decrease the residual or composite margin in the building block approach. The interest would be accreted over the period the insurer expected to receive the premiums (which would generally be no longer than the coverage period) and the residual margin (in the approach proposed in the IASB's ED) would be amortised over the coverage period thus offsetting one another. The composite margin (in the approach proposed in the

FASB's DP) is proposed to be amortised over the coverage and claims paying period, which would provide a partial but not complete offset.

99. In the modified approach, the discount amount of the pre-claims obligation is reflected in the measurement of the insurance contract. The accretion of interest on the pre-claims obligation would be offset in the same period by the amortisation of interest on the premiums receivable. If the receivable is not discounted the corresponding entry would presumably be included in the residual margin which would amortize over the coverage period and therefore offset.

100. While the income statement effects may net to zero it is also important to consider the usefulness of information provided on the statement of financial position. Paragraph 69 of the IASB's ED states that an insurer shall present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities. Based on this paragraph, the future premiums would be netted with the receivable, and therefore it would not be transparent to the users of the financial statements whether the future premiums are discounted and accreted or not from the face financials. However, the roll forward of balances would show the amounts separately.

101. When considering the tentative decisions from the revenue recognition project, the staff does not believe an insurer should adjust the pre-claims obligation (which is equal to the promised amount of consideration or premium) to reflect the time value of money because the period between when the insurance coverage is provided and the payment of the premium is generally less than one year. If the policyholder does not pay their premium when due, which is typically when the insurance coverage is being provided (with a limited relief period), the policy lapses and the insurer would no longer have an obligation.

102. In addition, the staff does not believe that the pre-claims liability for the contracts that meet the eligibility criteria to use the modified approach contains a significant financing component because the amount of premium charged is not substantially different if the policyholder paid in cash at contract inception or over the coverage period.

103. Several respondents suggested recording the pre-claims obligation separately from the post-claims obligation and the receivable. The staff will consider the

presentation of the statement of financial position at a future meeting. However, the staff do not believe the impact of discounting the balance sheet for the pre-claims obligation and a receivable that is expected to be received in a short period of time would provide meaningful information to the users of the financial statements.

104. Based on the analysis above, the staff believe that discounting the future expected premiums and accreting interest on those premiums is unnecessary in the context of a modified approach. Accreting interest for contracts that apply the modified approach adds a layer of unnecessary complexity to an approach that is intended to be a simplified measurement for insurance contracts.

Staff recommendation

105. The staff recommend recognizing the pre-claims obligation on an undiscounted basis. The staff do not believe specific criteria is required because the eligibility requirements to apply the modified approach already captures the staffs reasoning as discussed above.

Question 3 – Modified approach: preclaims obligation discounting
Do the Boards agree with the staff recommendation that: (a) The measurement of the pre-claims obligation at initial recognition should include the premium, if any, received at initial recognition, plus the undiscounted value of future premiums?

Premium allocation pattern

106. Paragraph 58 of the IASB ED proposes the pre-claims obligation is reduced over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) On the basis of the passage of time, but

(b) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time

Related tentative decisions

107. In the revenue recognition project, the Boards tentatively decided that to recognize revenue for a service, an entity must determine that a performance obligation is satisfied continuously and then must select a method of measuring progress toward complete satisfaction of that performance obligation. The Boards tentatively decided that an entity satisfies a performance obligation continuously if at least one of the following two criteria is met:

(a) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

(b) The entity's performance does not create an asset with alternative use to the entity and at least one of the following is met:

(i) The customer receives a benefit as the entity performs each task.

(ii) Another entity would not need to reperform the task(s) performed to date if that other entity were to fulfil the remaining obligation to the customer.

(iii) The entity has a right to payment for performance to date even if the customer could cancel the contract for convenience.

Feedback received

108. Most respondents did not comment on the premium allocation pattern however, a few respondents requested additional clarification on the criterion in paragraph 58(b) of the IASB's ED.

Staff analysis

109. The proposed model is consistent with the current approach in many jurisdictions today for most non-life insurance contracts.

110. The proposed model is consistent with the tentative decisions in the revenue recognition project: an entity must select a method of measuring progress toward complete satisfaction of a performance obligation. An insurer stands ready during the coverage period. If an event occurs, the insurer would be required to pay the insured.

111. Additionally, particular types of contracts would not meet the criteria that a performance obligation is satisfied equally throughout the coverage period. This would be the case if the insurer's amount of risk changes over the coverage period. Examples of types of insurance where the amount of risk changes over the coverage period are mostly related to seasonal events such as hurricane, hail or fire season, and certain warranty and surety insurance coverage as well as certain health related coverages. For these types of contracts, the staff believe that the pre-claims obligation should be reduced in proportion to the expected pattern of claims (for example, for hurricane coverage, the reduction in the pre-claims coverage would be weighted heavily to the hurricane season).

Staff recommendation

Question 4 – Modified approach: Premium allocation pattern

Do the Boards agree with the staff recommendation that:

The preclaims obligation should be reduced to reflect satisfaction of the performance obligation to provide coverage. The performance obligation is satisfied as the insurer provides insurance coverage as follows:

(a) On the basis of time, but

(b) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

Onerous contract test

112. Paragraph 60 of the IASB's ED states:

(a) An insurance contract is onerous if, at initial recognition or subsequently, the present value of the fulfillment cash flows relating to future insured claims that are within the boundary of an existing contract exceeds the carrying amount of the pre-claims obligation. If a contract is onerous, the insurer shall recognize an additional liability and a corresponding expense, measured as the difference between the carrying amount of the pre-claims obligation and the present value of the fulfillment cash flows.

Related tentative decisions

113. In the revenue recognition project, the Boards tentatively decided that the unit of account for the onerous test should be the contract, specifically, the remaining performance obligations in the contract. The Boards also tentatively affirmed the proposal in the Exposure Draft, *Revenue from Contracts with Customers,* that the costs to be included in the onerous test and in measuring an onerous liability should be the costs that relate directly to satisfying the remaining performance obligations.

Feedback received

114. Many respondents questioned how the modified approach achieved simplicity if an onerous contract test were required quarterly or annually.

115. Respondents noted that it was not clear whether the test would be required gross or net of reinsurance.

116. Some respondents did not believe it was appropriate to include a risk adjustment as part of the onerous contract measurement for a modified approach.

117. Some respondents proposed it was operationally too difficult to perform the test at a cohort level and thought it should occur at the portfolio or higher level. Others felt the tests should be performed at the level with which contracts are priced and managed.

118. Several respondents proposed developing qualitative criteria to determine if an onerous contract test should be performed. This will improve the flexibility of the modified approach while permitting a more robust test when it is suspected an onerous contract exists. Current Canadian, UK, and US GAAP procedures for determining premium deficiency were cited as potential models for this approach.

Staff analysis

119. The staff have identified three main components of the onerous contract test:

(a) Frequency of testing

(b) Level of measurement

(c) Components of the calculation

<u>Frequency of testing</u>

120. Paragraph 60 of the IASB's ED states "*an insurer shall update the measurement of the additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous*." This would require the test to be performed each period.

121. Many respondents noted that requiring the test to be performed each reporting period was burdensome and did not simplify the model. In most situations a contract will not be onerous. Some responded that the test should not be required to be performed each reporting period if certain qualitative factors did not indicate there could potentially be an onerous contract.

122. A qualitative test to indicate whether certain types of assets may be impaired is used in both US GAAP and IFRSs. Those qualitative tests rely on factors or indicators to evaluate whether or not an asset is impaired. In IFRSs for example, IAS 36, *Impairment of Assets*, requires an entity to assess at the end of each reporting period whether there is any indication that an asset may be impaired and provides examples of indicators (both internal and external). In US GAAP for example, long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that the carrying amount of those assets may not be recoverable. Topic 360, *Property, Plant, and Equipment*, provides examples of such events or changes in circumstances. Another example in US GAAP is for testing goodwill for impairment between annual tests (effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2010). Under the pending content of Topic 350, *Intangibles—Goodwill and Other*, interim impairment testing for goodwill is needed only if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. That Topic also provides examples of such events or circumstances. Also in US GAAP (Topic 320, *Investments—Debt and Equity Securities*), examples of indicators of when an impairment of an equity security classified as available-for-sale may be other than temporary.

123. While the guidance referred to above is for the assessment of the impairment of assets the reason for the qualitative criteria could be analogized to an assessment of an onerous liability. That is, there are numerous factors to be considered in an evaluation of impairment and their relative significance will vary from case to

case. In addition, performing a full impairment test/onerous contract test could be costly and time consuming.

124. Some of the guidance referred to above requires an annual impairment test regardless of indicators of impairment. Because of the nature of the types of contracts that would be eligible for the modified approach and that particular qualitative characteristics are strong indicators that insurance contracts are not onerous, the staff does not believe an annual impairment test is required.

125. The staff considered several characteristics that could indicate that an insurance contract may be onerous:

(a) Combined loss ratio[1] for the current year in-force business is in excess of 100%:

(i) It is a strong indicator that the pre-claims obligation is not onerous if the combined loss ratio for the current year in-force business in the claims period, when the "losses" are determined using the present value of the expected cash flows, is less than 100%.

(b) Significant increase in the frequency or severity of losses:

(i) while the combined loss ratio for the insurance liability in the claims period may be less than 100%, an indicator that the combined loss ratio may increase for a portfolio of contracts is if the claims being reported are more frequent or severe.

(c) Characteristic of the risk profile of the business written has changed:

(i) a company that does not have sufficient historical experience with particular types of insurance may require a higher threshold to determine that a contract is not onerous.

126. The staff believes that these qualitative factors, amongst others, could be an indication of whether or not a contract may be onerous and therefore whether or not the onerous contract calculation needs to be performed.

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[1] Combined loss ratio is generally defined as the sum of the ratio of losses and loss expenses to premiums earned (loss ratio) plus the ratio of statutory underwriting expenses to premiums written (expense ratio) after reducing both premium amounts by dividends to policyholders and is typically used by management to evaluate the performance of underwriting operations.

Level of measurement

127. Paragraph 60 of the IASB's ED states:

   (a) To determine whether insurance contracts are onerous and, if applicable, to measure the amount of additional liability, the insurer shall aggregate the insurance contracts into a portfolio and with a portfolio by similar date of inception.

128. In the ED and DP, the boards defined a portfolio of insurance contracts as: *"Contracts that are subject to broadly similar risks and managed together as a single portfolio"*

129. This definition could allow insurers to combine lines of business where the losses could evolve substantially differently. For example, some non-life insurers may argue that they have two portfolios: commercial lines and personal lines. Within the commercial lines, the company may write commercial auto, workers compensation and surety. Using the qualitative factors discussed above, surety could have loss ratios in excess of 100% while commercial auto may be significantly below a 100% loss ratio and together may have less than 100% loss ratio.

130. Some staff believe that because of the concerns noted above, that the onerous contract test should be performed at the line of business (type of product) level instead of the portfolio level because it would provide an earlier indication that particular contracts may have a loss. The staff plan to bring forward an analysis on the definition of a portfolio at a future meeting. Therefore, the staff believe that the decision about what level to perform an onerous contract test should be deferred until the boards determine the definition of a portfolio.

Components of the calculation

131. Insurers are required to perform an onerous contract test in many jurisdictions under current GAAP. In some jurisdictions the test is performed using, the undiscounted expected cash flows and considers anticipated investment income as a factor in the onerous contract test.

132. The IASB's ED identifies a contract as onerous if the carrying amount of the preclaims obligation is less than the present value of fulfillment cash flows (including a risk adjustment by definition). The board tentatively decided that the objective of the risk adjustment is the measure the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected.

133. The staff believe the purpose of an onerous contract test is to determine the amount by which the expected claims, claim adjustment expenses, policyholder dividends, unamortized acquisition costs, and maintenance costs (including unpaid commissions) exceed the related income (unearned premium reserve and any future installment premiums).

134. The boards tentatively decided that an insurance contract liability under the building block approach should be measured as the present value of the expected cash flows. The expected cash flows should include all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts. Anticipated investment income would not be explicitly included in the expected cash flows, although are implicitly included by using the present value of expected cash flows, albeit the rate would differ based on the boards tentative decisions on discount rate.

135. Therefore, the staff believe the onerous contract test should be performed using the present value of the expected cash flows.

136. Feedback from respondents indicated that including a risk adjustment in the onerous contract test could result in losses being recorded for contracts that have profit. This is because some view the risk adjustment as deferred profit that will be earned if the actual expected cash flows do not exceed those determined at contract inception.

137. Although the boards have not yet decided whether an explicit risk adjustment will be required under the building block approach, including a risk adjustment or a composite margin in the onerous contract test would be inconsistent with the tentative decisions reached in the revenue recognition model which does not require a risk adjustment to be included in the onerous contract test.

138. The staff believe that determining that a contract is in a loss position based on the expected cash flow plus a portion of the expected profit would be unduly burdensome.

139. As such, the staff believe the accounting for the insurance liability in the pre-claims period should be consistent with the revenue recognition project and therefore be based off the expected cash flows without a risk adjustment or composite margin.

Question 5 – Modified approach: onerous contract test
Do the Boards agree with the staff recommendation that: (a) An onerous contract test should be performed if qualitative factors, such as combined loss ratio exceeds 100%, there is a significant increase in the severity or frequency of claims and there is a change in the characteristics of the risk profile (b) An additional liability should be recognized if the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation

Permit vs. Require

140. Paragraph BC147 in the IASB's Basis for Conclusions on the ED indicates that the board proposed to require insurers to apply the modified approach to all contracts that meet the specified conditions to ensure comparability between the financial statements of different insurers.

Feedback received

141. The majority of respondents, especially preparers that write both life and non-life business, would like the modified approach to be permitted rather than required.

142. Some responded that for comparability a modified approach should be required for contracts that meet the eligibility criteria.

Staff analysis

143. The staff considered whether the decision to permit or require a modified approach as opposed to the building block approach should depend on whether

the results from the modified approach are identical to that of the building block approach.

144. The results from the building block approach and the modified approach were identical under the ED only if there were no changes in expected cash flows and were not equivalent under the DP.

145. Based on the staff recommendations for the measurement of the modified approach, the results will not be equivalent to the building block approach.

146. Paragraph BC147 in the Basis for conclusions on the exposure draft states:

   (a) […] the modified approach is intended to provide a practical short cut that combines the strengths of the approach now proposed for insurance contracts in general with the virtues of existing approaches for these contracts; for these contracts, they believe that the incremental benefits of switching fully to the new model are not sufficient to justify the costs.

147. Some entities have the capabilities to perform the full building block approach, which in most cases is because the insurer writes both life and non-life insurance today. These entities have various reasons for wanting to apply the building block approach, including for consistency within their entity.

148. The staff believe that with appropriate disclosures of an entity's policies, users of the financial statements can determine the approximate differences for the significant items and therefore, entities should be given the option of applying the building block approach or the modified approach.

Staff recommendation

Question 6 – Modified approach: permit versus require
Do the Boards agree with the staff recommendation that: An insurer should be permitted but not required to apply the modified approach for contracts that meet the eligibility requirements?

Appendix A

Examples of non-life contracts that may have a duration longer than one year:

1. Surety contracts that insure a construction period which may be 3-5 years
2. Construction policies for general liability that extend for the duration of the construction
3. Small commercial coverage policies where there is no cost benefit to perform annual underwriting
4. Contracts for fire coverage in Japan, which are typically 1-5 years but may be up to 30 years when bundled with mortgage loans
5. Contracts in a business combination, in which an acquiring entity will write longer coverages to align the effective dates with their existing blocks of business
6. Renewal policies that start on an "off-date" to align with other effective dates. Typically 15- 18 month policies. This often happens in business combinations
7. Satellite business which covers the period of time from launch through duration of orbiting
8. Claims made policies, which cover past incurred claims, and current incurred claims that are reported during the current year. These are typically accounted for as short-duration contracts today because the coverage is based on a reported basis. However, these contracts may also have extended reporting for a limited number of months thus extending the reporting period to longer than one year
9. Death, disability and retirement coverage (DDR) which is provided for medical malpractice insurance and is typically free if the medical malpractice insurance is in place for longer than a specific stated period (i.e., 10 years)

Appendix B

Typical types of contracts include the following:

Coverage type	Coverage description
Property and Casualty Contracts	
Fire and allied lines	includes coverage for fire, windstorm, hail, and water damage (but not floods
Ocean marine	includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages
Inland marine	covers property being transported other than transocean. (It also includes floaters, which are policies that cover movable property, such as a tourist's personal property.)
Workers' compensation	compensates employees for injuries or illness sustained in the course of their employment.
Automobile	covers personal injury or automobile damage sustained by the insured and liability to third parties for losses caused by the insured.
Multiple peril	is a package coverage including most property and liability coverage except workers' compensation, automobile insurance, and surety bonds.
Professional liability	covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service
Miscellaneous liability	covers most other physical and property damages not included under workers' compensation, automobile liability, and multiple peril policies. Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property
Fidelity bonds	covers employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees
Surety bonds	provides for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits.)
Accident and health	covers loss by sickness or accidental bodily injury. It also includes forms of insurance that provide lump-sum or periodic payments in the event of loss by sickness or accident, such as disability income insurance and accidental death and dismemberment insurance.

Life Insurance Contracts	
Traditional whole life contracts	Payment of the face value of the contract is made upon the death of the insured. These contracts are designed to provide a fixed amount of insurance coverage over the life of the insured
Term life contracts	Life insurance coverage is provided for only a specified period and usually does not include the accumulation of cash values
Credit life	Term insurance that is issued to borrowers for the amount and term of the outstanding debt. Credit life insurance can be level or decreasing term insurance (the amount of life insurance coverage decreases in proportion to decreases in the amount of outstanding debt) and is usually associated with residential mortgages and consumer debt. Credit life contracts provide benefits should the borrower die before the debt is repaid or expire at the end of the term.
Endowment contracts	Principally savings contracts that incorporate an element of life insurance protection so that if the insured dies before the contract matures, the face amount of the contract is paid to a beneficiary. If the insured is still living at the maturity date, he or she receives the face amount of the contract. Endowment contracts mature at a specified attained age of the insured or at the end of a specified period.
Universal life contracts	Typically, universal life contracts are long duration contracts with terms that are not fixed or guaranteed with respect to premium amounts, expense assessments, or benefits accruing to the contract holder. Such contracts divide the pure insurance protection, the related expense charge, and the cash value accumulation into separate and distinct components.
Variable life contracts	Long duration contracts designed to give the contract holder the ability to choose the contract's underlying investment vehicle from among the investment options offered by the life insurance entity and to bear the risk of investment performance. These contracts have features whereby death benefits, cash surrender values, and premium amounts vary with the investment performance of a specific separate pool of assets, usually a separate account.
Accident and Health Insurance Contracts	
Disability income insurance contracts	Coverage protects the insured against loss of income as a result of the partial or total inability to work as a result of illness, injury, or disease. The contracts are either short term contracts that provide benefits for a limited number of weeks or long term contracts that provide benefits for an extended period. Most long

	term disability contracts provide benefits to age 65 or for life. The long term contract is primarily characterized by an extensive elimination period, usually 30 to 180 days, before benefits begin.
Medical expense insurance	This broad base of coverage is designed to indemnify the insured against incurred losses covering virtually all kinds of expenses associated with medical care and related services. Contracts differ widely among insurers as to total dollar limits and specific benefits covered. These generally contain some method of cost sharing of medical costs with the contract holder through either copayment plans, which specify a formula for the sharing of actual medical expenses between the insurer and the contract holder, or deductibles, which specify a dollar amount of medical expense the contract holder generally must pay before the insurance coverage begins, or both.
Long term care contracts	These are primarily contracts that provide coverage for nursing home or other continuing care services related to long term disabilities or the elderly who cannot care for themselves for medical reasons. These contracts typically offer coverage based on a preset limit on per-day reimbursement for long term care. The contracts are generally guaranteed renewable, with an option that automatically adjusts the coverage level with inflation indexes.
Annuity Contracts	
Annuity Contracts	an arrangement under which the contract holder is guaranteed to receive benefits over a fixed or variable period, commencing either immediately or at some future date. Annuities provide either for payment of benefits until the insured dies or for continued payments to a beneficiary until a specific number of periods are met. Annuity contracts are either fixed or variable. Annuity products with nontraditional terms have been and continue to be developed. These products may have both fixed and variable features, or other nontraditional features