IASB/FASB Meeting
Week of 18 July 2011
FASB ED Session 14 July 2011

IASB Agenda reference	**8A**
FASB Agenda reference	**71A**

Staff Paper

Project	**Insurance Contracts**
Topic	**Premium allocation approach: Overview**

Purpose of this paper

1. This paper provides (in paragraphs 24-28) an introduction to two papers that discuss ways of simplifying the premium allocation approach proposed for short duration contracts in the IASB's exposure draft *Insurance Contracts* (ED):
   (a) Agenda paper 8B: *Premium allocation approach – a simplification of the building block approach*
   (b) Agenda paper 8C: *Premium allocation approach - A Two Model Approach*
2. This agenda paper also provides:
   (a) Background to the premium allocation approach proposed in the IASB's ED (paragraphs 6-21).
   (b) The tentative decisions made to date on the premium allocation approach (paragraphs 22-23).
   (c) An appendix, setting out a comparison of the premium allocation approach proposed in the ED to US GAAP and the building block approach
3. This paper does not discuss the following topics:
   (a) Presentation for short duration contracts to which the premium allocation approach applies, which we discuss as part of the presentation papers.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

(b) How a single margin model would work with contracts eligible for the premium allocation approach. This will be discussed at a future meeting.

4. This paper does not ask for decisions from the boards.

Background

5. This section provides background information, including:

   (a) an overview of the premium allocation approach as proposed in the IASB's ED and the FASB's DP (paragraphs 6-9).

   (b) a note on terminology (paragraph 10).

   (c) a summary of the relevant comments received from respondents to the IASB's ED and the FASB's DP (paragraphs 11-21)

Summary of the IASB's proposals and the FASB's preliminary views

6. Paragraphs 54 - 60 of the IASB's ED states the following:

> 54 [The premium allocation approach applies] to insurance 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 in accordance with paragraph 12 [of the ED].
>
> 55 For those contracts, an insurer shall:
>
> (a) measure its pre-claims liability by allocating premiums over the coverage period as described in paragraphs 56-60.
>
> (b) measure its claims liability at the present value of the fulfilment cash flows, in accordance with paragraphs 22–46 [of the ED (ie. the building block approach)].
>
> 56 The pre-claims liability is the pre-claims obligation (as described in paragraphs 57 and 58), less the expected present value of future premiums, if any, that are within the boundary of the existing contract.

57 For insurance contracts specified in paragraph 54, an insurer shall measure its pre-claims obligation at initial recognition as:

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

(b) the incremental acquisition costs.

58 Subsequently, the insurer shall reduce the measurement of the pre-claims obligation 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.

59 An insurer shall accrete interest on the carrying amount of the pre-claims liability, using the discount rate specified in paragraph 30 [of the ED], updated in each reporting period.

60 An insurance contract is onerous if, at initial recognition or subsequently, the present value of the fulfilment 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 recognise 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 fulfilment cash flows. To determine whether insurance contracts are onerous and, if applicable, to measure the amount of the additional liability, the insurer shall aggregate the insurance contracts into a portfolio and, within a portfolio, by similar date of inception. An insurer shall update the measurement of that additional liability at the end of each reporting period and reverse it to the extent that the insurance contract is no longer onerous.

7. Paragraph BC145 –BC148 of the Basis for Conclusions to the ED stated:

BC145 The Board proposes that the pre-claims liability arising from some short-duration contracts (ie contracts for which the coverage period is approximately one year or less, and meeting other conditions specified in paragraph 55) should be measured using an unearned premium approach, unless the contract is onerous. Such an approach is consistent with the customer consideration approach proposed in the exposure draft *Revenue from Contracts with Customers*.

BC146 The Board believes 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 fulfilment cash flows and the

residual margin (and achieves a similar result at a lower cost). This is because if significant changes in estimates are made during the coverage period of a short-term duration contract, those changes are more likely to be unfavourable (leading to losses) than favourable (leading to gains). The insurer would recognise these losses because of the requirement to recognise an additional liability when the contract becomes onerous. Thus, requiring an insurer to apply the full measurement model for these contracts would not generate sufficient benefits to justify the costs of adopting the new approach.

BC147 The Board considered whether the modified approach should be permitted but not required. Proponents of that view argue that 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. Those proponents argue that requiring insurers to use that short cut rather than merely permitting them to do so is inconsistent with the rationale for the short cut. However, to ensure comparability between the financial statements of different insurers, the Board proposes to require insurers to apply the modified measurement approach to all short-duration contracts that meet the specified conditions.

BC148 To maintain consistency with the measurement for insurance contracts generally, the modified approach also includes the following features:

(a) The pre-claims obligation and the expected present value of the future premiums are presented as a single insurance contract asset or liability (see paragraph BC156).

(b) Interest is accreted on the insurance contract asset or liability, if the effect of the time value of money is material.

(c) The basis for the onerous contract test is the present value of the fulfilment cash flows, which is the measurement for insurance contracts generally. Considering the short duration of the coverage period, the level of aggregation for the onerous contract test would be within the portfolio of insurance contracts, by similar date of inception.

(d) The incremental acquisition costs are deferred and presented as a deduction from the part of the premium allocated to the remaining coverage period. Those deferred incremental acquisition costs would be recognised as an expense over time in a pattern consistent with the pattern in which the premium is recognised as revenue.

8. Paragraph 105 of the FASB's DP stated the following:

105 Several Board members expressed a preliminary view that a modified approach would be applied to some insurance contracts (for example,

certain short-duration contracts). The Board has not determined the extent to or the conditions under which a modified approach would apply. Current guidance requires that insurance contracts be classified as short duration or long duration depending on whether the contracts are expected to remain in force for an extended period. The period of short duration is not explicitly defined, but in practice is generally one year or less. The Board is considering whether current guidance is appropriate for determining the insurance contracts to which a modified approach would apply or whether stakeholders recommend any improvements.

9. Paragraph 106 of the DP further stated:

106 Although several Board members agree with some of the recognition and measurement provisions for the modified approach in the IASB's Exposure Draft, the Board has not determined the following:

(a) Whether incremental acquisition costs would reduce the pre-claims liability

(b) Whether interest would be accreted on the carrying amount of the pre-claims liability

(c) How the onerous test would be applied to the pre-claims liability

(d) How insurance contracts would be presented in the financial statements.

Terminology

10. In discussing the proposals for the measurement of the pre-claims liabilities of some short-duration contracts, the staff found that the term "pre-claims" liability was unclear and had led to confusion. The pre-claims liability refers to the insurer's obligation to stand ready to pay for *future* insured events covered by *existing* contracts. The staff propose that the term "pre-claims liability" be replaced with a more descriptive term, namely "liability for remaining coverage". Furthermore, the staff propose that the term "claims liability" be replaced with "liability for incurred claims" (ie the obligation to pay claims for insured events that have already occurred) and "modified approach" with "premium allocation approach".

Comments received on the ED/DP

11. A high level summary of the comments received is provided here. Specific feedback on each topic is included with the analysis of the respective topics.

12. Some respondents believe short duration contracts (typically non-life contracts) are fundamentally different from long duration contracts (typically life contracts) and therefore belong under a separate accounting model. Consequently, they 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. However, most respondents support using a premium allocation approach as a proxy for the building block approach though many suggested further simplification to the proposals in the ED (see paragraph 15). This support was expressed by all types of respondents, including users; preparers; accountants; actuaries; industry groups and national standard setters.

13. Respondents were primarily concerned with three aspects of the modified approach:

    (a) The cost-benefit ratio – they did not believe the modified approach provided sufficient simplification of the full model (ie. the approach was "over-engineered"). In other words, respondents believed that the full building block approach overcomplicates the accounting required for some contracts.

    (b) The contracts for which the premium allocation approach should be applied. In particular, some stated that a contract with a coverage period of less than twelve months does not necessarily differ from a contract with a coverage period of more than twelve months.

    (c) whether the modified approach should be permitted rather than required.

14. In addition, some question how the presentation proposals for short-duration contracts interact with those for the building block approach. We do not discuss the presentation proposals in these papers.

Cost-benefit

15. Many respondents were concerned about the cost-benefit ratio of applying a modified approach and stated that it was unclear how a significant benefit is derived if preparers using the modified approach are required to:

    (a) Accrete interest in the pre-claims period,

    (b) Discount expected future premiums, and

    (c) Calculate a risk adjustment as part of an onerous contract test

    They believe that these features, in effect, make them apply something close to the full building block approach for these contracts providing no simplification or benefit from reduction in costs.

Eligibility

16. Some respondents were concerned that applying a one-year cut off for eligibility for the premium allocation approach would result in different accounting for similar products with different durations. For example, some non-life contracts may have a duration longer than one year. Examples cited included: surety contracts that insure a construction period which may be 3-5 years and contracts assumed in a business combination, in which an acquiring entity will write longer coverages to align the effective dates with their existing blocks of business.

17. Some respondents also interpreted the word 'approximately' very narrowly, and took the view that the eligibility criteria would prohibit the use of the premium allocation approach even if some contracts within a portfolio had a term of, say, 15 months.

18. Respondents put forward various suggestions for relaxing the criteria. For example, they suggested that the boards could permit the premium allocation:

    (a) for all contracts with a coverage period of less than three years. Some respondents believe that this would capture most non-life insurance contracts.

(b) for the whole of a portfolio that combines long and short-duration contracts if those long-duration contracts are insignificant in the context of the entire portfolio or the insurer's business.

(c) for contracts that meet the existing definition of 'short-duration' in US GAAP, which include contracts that provide insurance protection for a fixed period of short duration and enable 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 premiums charge or coverage provided.

(d) when an insurer has small volumes of longer term contracts in a predominantly short-term book of contracts.

19. Other respondents suggested developing more principled or judgement-based criteria in place of the arbitrary one-year cut-off. For example, the approach could be permitted if:

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

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

(g) the profitability of the contract is primarily from underwriting income or loss rather than investment results.

(h) the claims payment period is short.

(i) there is relatively little uncertainty in the amount and timing of claims.

(j) the measurements determined applying the premium allocation approach are not materially different from those determined applying the main measurement model.

Permit or require

20. Most think the premium allocation approach should be permitted rather than required. This view was articulated vocally at each of the roundtables, and particularly in the comment letters from insurers that write both life and non-life contracts. Although mandatory application of the modified approach for specified contracts might improve comparability, it would also cause composite insurers to

apply two different models to similar products. Furthermore, some state that permitting an option to apply the modified approach would be more consistent with the view that the modified approach is a simplification of the building block approach, rather than an alternative model.

21. A small number think that the modified approach should be mandated. This includes many, but not all, users.

Recent decisions on the premium allocation approach

22. The boards discussed the premium allocation approach at the April 27 2011 joint meeting and tentatively decided the following:

    (a) The insurer should reduce the measurement of the pre-claims obligations over the coverage period 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.

    (b) An insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.

23. In addition, the IASB tentatively decided that an insurer should deduct from the pre-claims obligation measurement the acquisition costs that would be included in the measurement of the insurance contract liability under the building-block approach. The FASB did not vote on this issue.

Papers for this meeting

24. During the April joint meeting the boards debated whether a premium allocation approach should be provided as:

    (a) a simplification of the building block approach for some types of contracts; or

    (b) a separate model to account for short duration contracts.

25. Both those who regard the premium allocation approach as a proxy for the building block approach, and those who regard it as a separate approach agree that:

    (a) for some types of contracts, there needs to be an approach similar to the existing unearned premium approach widely used in existing practice for some types of insurance contracts.

    (b) In some circumstances (eg at inception and for very straightforward contracts with minimal changes in assumptions about future claims under existing contracts), a premium allocation approach such as the unearned premium approach or a revenue recognition approach would be the same as the building block approach. When that is the case, the cost of applying the building block approach would be excessive, given that a less costly approach could give similar information.

    (c) the comment letters were clear that the premium allocation approach proposed in the ED was overengineered and needed further simplification.

26. The reasons for specifying a premium allocation approach affect the simplifications that should be considered and the eligibility criteria for determining when those simplifications would apply:

    (a) If the intention is to provide a proxy, the simplifications and eligibility criteria are linked: we could provide a large degree of simplification for a relatively small number of contracts, or a small degree of simplification for more contracts.

    (b) If the intention is to provide a second model, there are no such constraints.

27. Accordingly, agenda papers 8B and 8C approach the question of how to simplify the premium allocation approach proposed in the ED through two different routes:

    (a) Agenda paper 8B takes the path of determining first the desired simplifications by selecting a model and then setting eligibility criteria by identifying those contracts for which those

simplifications would result in similar accounting to the building block approach. In agenda paper 8B, the IASB staff proposes to use the model developed in the project on revenue recognition because it secures most of the simplifications requested in the comment letters, and has the advantage of reducing the pressure on the distinction between revenue contracts and insurance contracts.

(b) Agenda paper 8C takes the path of identifying the characteristics of short duration contracts that make them fundamentally different economically and therefore the building block approach is not considered appropriate. The eligibility requirements and simplifications chosen are meant to capture those fundamental differences. In agenda paper 8C, the FASB staff propose measurement requirements for contracts for which they do not believe the building block approach to be appropriate.

28. The two papers recommend a similar model, with differences in the eligibility criteria. The table on the following pages summarise the similarities and differences (with differences shaded):

	ED Approach	"One Model" Approach	"Two Model" Approach
Eligibility for "modified" measurement approach	"Modified" measurement approach should be applied to contracts that: • have a coverage period of approximately one year or less; and • after unbundling, do not contain embedded options or other derivatives that significantly affect the variability of cash flows.	a) Contracts should be eligible for the premium allocation approach if that approach would produce measurements that are a reasonable approximation of those that would be produced by the building block approach. b) A contract should be deemed to meet the condition in (a) without further investigation if both of the following conditions apply: i. the coverage period is approximately one year or less; and ii. the contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives. c) The boards should add guidance to avoid overly-restrictive interpretations of 'approximately one year'. This guidance could clarify that contracts could meet this definition even if they are several months longer than one year and	A portfolio of insurance contracts are eligible for the modified approach if all the following conditions are met: • the compensation to the policyholder is based on the amount of the incurred insured loss which is typically variable up to the amount of the policy limit and not a specified amount (other than the limit) in any given contract • the period of time between premium receipt and the date of loss is insignificant • the pricing of the premiums does not include risks relating to future renewal periods.

	ED Approach	"One Model" Approach	"Two Model" Approach
		even if there are a few longer-duration contracts within a portfolio of predominantly one-year contracts.	
Required or permitted if eligible?	Required	Permitted	Some staff support requiring the premium allocation approach Some staff support permitting the premium allocation approach
Revenue recognition of premium	Recognized over the coverage period of the contract on the basis of time, but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time	Recognized over the coverage period, on the basis of time, but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.	Recognized over the coverage period, on the basis of time, but 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	Perform an onerous contract Additional liability recognized if the amount determined using the building block approach exceeds the carrying amount of the liability for remaining coverage. Thus, onerous test includes a risk adjustment.	Perform an onerous contract test if and when the facts and circumstances indicate that a portfolio has become onerous during the coverage period. Additional liability recognized if the present value of the expected cash outflows exceeds the carrying amount of the liability for remaining coverage. Onerous test does not include a risk adjustment.	Perform an onerous contract test if and when the facts and circumstances indicate that a portfolio has become onerous during the coverage period. Additional liability recognized if the present value of the expected cash outflows exceeds the carrying amount of the liability for remaining coverage. Onerous test does not include a risk adjustment.

	ED Approach	"One Model" Approach	"Two Model" Approach
Discounting of the liability for remaining coverage and accretion of interest	Discounting of the liability for remaining coverage as well as the accretion of interest is required.	*No* discounting of the liability for remaining coverage or the accretion of interest is required. (This decision assumes that either (a) the period between receipt of the premium and provision of coverage is one year or less, or (b) the effect would be immaterial).	*No* discounting of the liability for remaining coverage or the accretion of interest is required.
Acquisition costs	Liability for remaining coverage is measured net of incremental acquisition costs.	Recognise incremental acquisition costs as an asset, and amortise them over the coverage period, or, if the coverage period is one year or less, recognise all acquisition costs in the income statement when incurred. The incremental costs of obtaining a contract are the costs that the entity would not have incurred if the contract had not been obtained.	Pre-claims liability should be measured net of acquisition costs. An insurer is permitted to expense particular internal incremental acquisition costs that otherwise meet the criteria as set out in the most recent tentative decisions made by the IASB and the FASB. An insurer should disclose which acquisition costs are included in the pre-claims liability.

Appendix: Comparison of the premium allocation approach to US GAAP and the building block approach

1. The premium allocation 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.

2. Three key aspects of the short-duration insurance contract model under current US 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) The claims liabilities are measured on an incurred basis (that is, a claims liability is only recognized when an insured event has occurred).

   (c) A premium deficiency is recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceed related unearned premiums.

3. The table below summarizes the differences between the unearned premium approach under US GAAP, the premium allocation approach as proposed in the ED/DP, and the building block approach.

	Current US GAAP[1] (unearned premium) Approach	**Premium Allocation Approach proposed in ED**	**Building Block Approach**
Eligibility	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
Liability for remaining coverage - initial recognition.	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 fulfilment cash flows.
Revenue recognition during the coverage period	Recognized in proportion to the protection provided	Recognized in proportion to the protection provided (Same as US GAAP)	**Dual margin**: Recognize changes in risk adjustment to profit and loss based on measurement; recognize residual margin over coverage period; Adjust the residual margin for favorable and unfavorable changes in the estimates of future cash flows used to measure the insurance liability. **Single margin**: Recognize single margin over coverage and claims period as insurer satisfies its performance obligation; An insurer satisfies its performance obligation as it is released from

[1] Many other jurisdictions use the unearned premium approach in US GAAP as a basis.

	Current US GAAP[1] (unearned premium) Approach	Premium Allocation Approach proposed in ED	Building Block Approach
			exposure to risk as evidenced by a reduction in the variability of cash outflows; do not remeasure or recalibrate single margin to recapture profit already recognized
Onerous contract test	Depending on the US 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.

4. Thus, the key differences between the approach proposed in the ED and US GAAP are as follows:

   (a) The premium allocation approach proposed in the ED would discount the pre-claims liability for the time value of money

   (b) The ED proposed for the premium allocation approach that insurers use the building block model for the onerous contract test. That would include discounting for the time value of money (however, investment income is not included) and a risk adjustment (IASB only).

5. In terms of discounting liabilities for the time value of money, historically, U.S. insurers have only discounted liabilities for unpaid claims (in the claims period) if the claims were fixed and determinable or if the rate used was the same as that used for reporting to state regulatory agencies. This is similar to the approach used in many jurisdictions. However, a few jurisdictions such as Australia and Canada report discounted liabilities. To this point in the re-deliberations, the boards' tentative decisions about short duration contracts have been about the post-coverage period and include requiring discounting for all non-life long-tail claims. The boards also agreed that discounting of insurance liabilities should not be required when the effect of discounting would be immaterial.