IASB/FASB Meeting
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FASB ED Session 14 July 2011

IASB Agenda reference **8C**

FASB Agenda reference **71C**

Staff Paper

Project	**Insurance Contracts**
Topic	**Premium Allocation Approach: A Two Model Solution**

Purpose of this paper

1. During the April 27th joint meeting some board members and staff expressed the conclusion that the purpose of the premium allocation approach should not be to provide a simplification of the building block model but rather to provide a separate model to account for short duration contracts.

2. The purpose of this paper is to determine:

   (a) if a separate and distinct model is needed for short duration contracts (a two-model approach),

   (b) which model would be an appropriate choice for a two-model approach, and

   (c) when that model would apply

3. This paper does not discuss the following issues:

   (a) discounting of the liability for incurred claims, or

   (b) how the single margin tentatively adopted by the FASB would work with contracts eligible for the premium allocation approach

4. This paper only addresses the pre-claims period accounting for short duration contracts as the premium allocation approach provided for in the ED only addressed the pre-claims period.

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.

5. The staff provided the boards with an overview and high-level summary of comments received from respondents to the ED and DP for the premium allocation approach at agenda paper 8A/71A.

Structure of this paper

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

   (a) Summary of staff[1] recommendations

   (b) Background, including:

      (i) a summary of the IASB's proposals and the FASB's preliminary views

      (ii) a summary of the relevant comments received from respondents to the IASB's ED and the FASB's DP (provided by section)

   (c) Staff analysis, including:

      (i) comparison of short and long duration contracts (the need for two models),

      (ii) what is an appropriate model,

      (iii) eligibility requirements under a two model approach,

      (iv) discounting of the liability for remaining coverage,

      (v) treatment of deferred acquisition costs,

      (vi) the measurement components of an onerous contract test, and

      (vii) whether to permit or require the approach

Summary of staff recommendations

7. The staff supporting the approach in this memo have concluded that a premium allocation approach (as a separate model) would represent the characteristics of contracts for which a revenue recognition or allocation model in the pre-claims

[1] The views expressed in this paper are not unanimously held by all staff on the insurance contracts project. For the views of other staff on this Topic, please refer to Agenda Paper 8B/71B. For ease of reading we will refer to "the staff" throughout the rest of the paper.

period is more appropriate, rather than provide a simplification or proxy for the building blocks model. Those staff recommend:

(a) A portfolio of insurance contracts are eligible for the premium allocation approach if all the following conditions are met:

   (i) 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

   (ii) the period of time between premium receipt and the date of loss is insignificant

   (iii) the pricing of the premiums does not include risks relating to future renewal periods

(b) An insurer should include in the measurement of the liability for remaining coverage at initial recognition the premium, if any, received at initial recognition, plus the undiscounted amount of expected future premiums, if any, that are within the boundary of the existing contract.

(c) The boards reconfirm the liability for remaining coverage should be measured net of acquisition costs.

(d) An insurer is permitted to expense particular internal direct acquisition costs that otherwise meet the criteria as set out in the most recent tentative decisions made by the IASB and the FASB.

(e) If the boards agree to permit an insurer to expense particular internal direct acquisition costs, an insurer should be required to disclose which acquisition costs are included in the liability for remaining coverage.

(f) An additional liability should be recognized if the present value of the expected cash outflows exceeds the carrying amount of the liability for remaining coverage.

(g) Permit vs. require the premium allocation

   (i) Some staff recommend permitting the premium allocation approach for those contracts that meet the eligibility criteria.

   (ii) Some staff recommend requiring the premium allocation approach for those contracts that meet the eligibility criteria.

Background

Summary of the IASB's proposals

8. The IASB explained in paragraphs BC145 and BC146 why they developed the premium allocation approach. Those paragraphs provide the following explanations respectively:

   (a) [...] 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*.

   (b) [...] 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).

Relevant comments received with respect to a two-model approach

9. The staff believe that the intent of the premium allocation approach was to establish a methodology that served as a simplification of the full building block model. Implicit in this view is the notion that the premium allocation approach provides a sufficient proxy for the full building block model when the benefits of using the full approach are not enough to justify the costs.

10. Many respondents agreed with the notion expressed in the preceding paragraph. Additionally, many expressed that a premium allocation approach should only be a simplification of the full building block model and should not be allowed otherwise.

11. However, others believe contracts of shorter duration are fundamentally different from contracts of longer duration warranting a separate and distinct model that is consistent with an unearned premium approach used in many jurisdictions today and is more akin to a revenue recognition or allocation model. The primary reason

for wanting a separate and distinct model is to remove the constraint of needing to achieve an approximation or sufficient proxy to the building block model from a measurement standpoint. Some believe this constraint effectively limits eligibility for the premium allocation approach to a narrower range of contracts thereby excluding other contracts that are managed and priced the same because they have the same economic characteristics.

12. Although the responses from those that want a separate model tended to focus on the particular aspects of the model (eg. eligibility, discounting, etc.), many respondents (particularly property / casualty and health preparers) commented that they wanted to maintain the existing unearned premium approach for non-life contracts, as users find it useful. These respondents commented that the premium allocation approach (with specific changes) should be treated as a separate measurement model as opposed to a modification or simplification to the proposed building-block model.

13. Some responses and recent outreach performed by the FASB staff would appear to support the notion expressed in the preceding paragraph. Our recent outreach indicates that users do not believe that current accounting for short duration contracts is “broken”. They have indicated that non-life and life insurance are fundamentally different and a single model is not necessary. The following comment received as part of the comment letter process is indicative of the recent feedback received during additional outreach performed:

> From an analyst’s perspective, there are numerous differences between life and PC businesses that suggest different measurement models are entirely acceptable, and preferable if the goal is to deliver meaningful information to investors. …Accounting should match as closely as feasible the underlying economics of the business. If two different businesses have differing economics (which I believe is true for PC and life), there is neither need nor value in forcing both into the same model.

Staff Analysis

14. As expressed in the opening of this paper, during the April 27th joint meeting some board members and staff concluded the premium allocation approach was a separate model. They based their conclusion on the following reasoning:

(a) The results obtained under a premium allocation approach are fundamentally different from those obtained under a full building block model. In the pre-claims period there is a test to determine if a contract is onerous versus re-measuring the contract, revenue is recognized over the coverage period, and a single margin or risk adjustment is not recognized until a claim is incurred. These characteristics alone would suggest the model is a separate and distinct one that focuses on collecting premiums to pay out short term obligations with potentially significant variance in frequency and severity as opposed to investing premiums over the long run to satisfy an amount that is primarily uncertain as to timing of the event.

(b) While some may believe the premium allocation approach is a simplified proxy for the full building block model in the pre-claims period, that is true in all instances only on day one. Changes in the expected present value of cash flows can create significantly different results between the models in subsequent periods. Furthermore, it is worth noting the recent decisions to unlock the residual margin could create additional complexities. For example, in the ED, the IASB proposed amortizing the residual margin over the coverage period thereby eliminating the differences by the end of the coverage period (leaving only interim reporting to differ). Given the recent decisions, the results would differ, depending on when the unlocking occurs.

Comparison of short and long duration contracts (the need for two models)

15. In agenda paper 8A/71A the staff reported the three primary concerns that respondents expressed about the premium allocation approach as proposed in the ED:

(a) The cost-benefit ratio – they did not believe the premium allocation 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.

16. Many of the suggestions offered by respondents to address the primary concerns were based on the notion that the business model for shorter duration (non-life type) contracts is fundamentally different from 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.

17. The staff examined these characteristics to determine whether these characteristics warrant a separate approach to account for these types of contracts. For simplicity and ease of reading, the staff referred to the contracts discussed as "non-life" and "life" as this is how these contracts 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)	Ongoing risks for a determined benefit to individual policyholders over time with significant time from inception of contract to incurrence of event and therefore payment of benefit
Primary performance indicators and metrics managed	Combined loss ratios, claims development	Margin analysis for investments, mortality, and morbidity; Actual to expected experience measures; Growth indicators based on premium volume
- 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	- Premiums and Discretionary premiums may continue over multiple periods; Discretionary premiums can change the amount of benefit payout; Risks not re-underwritten or re-priced annually or more frequently

18. The staff believe the primary risks covered and the key performance indicators managed form the basis for the arguments of a two-model approach. 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. Therefore, the staff examined how the risks covered affect the primary performance indicators and drive the management of these contracts, thus creating differences between non-life and life contracts.

19. The risks covered by non-life 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 the primary uncertainties of a property catastrophe contract involve the timing of the event (including whether the event happens) and the ultimate amount of the claim payment. As a result of the uncertain frequency and severity of the outcome, non-life contracts tend to be of a shorter duration than life contracts.

20. This shorter duration and difference in frequency and severity, in turn, translate 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, 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.

21. Rather than accepting premiums over time to invest for the long term, as is the case for life insurance, the insurer 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 over that period. This is different from life insurance where the performance of the entity is largely a function of the investment strategy because the insurer prices the premium based on the expectation of when, in the future, death will occur. The insurer considers the investment income that could be earned through its investment strategy until that time, which in most instances, occurs at a time significantly beyond initial recognition.

22. The differences discussed above is why the sector considers combined loss ratios and claims development 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 (ie the amount is variable up to a contract limit). The incurred insured loss contrasts with life contracts where the amount is typically specified in the contract. Users look to the combined loss ratios to determine whether the premium charged will cover the losses and the loss adjustment expenses. Users also look at the loss development tables to observe trends to help determine how well the company initially estimated its cash outflows for each accident year and subsequent adjustments that need to be made to the ultimate losses expected.

23. Some staff believe that the characteristics provided above create a category of contracts that are fundamentally different in the risks they cover and the way they are managed and that it would be more appropriate to account for the pre-claims period for these contracts using a separate and distinct model thus supporting a two-model approach. They believe that the objective of the premium allocation approach should be to represent the characteristics of those contracts, rather than to provide a simplification or proxy for the building block model.

24. Furthermore, the staff believe it is important to establish the objective in order to determine the eligibility requirements for using the premium allocation approach. Although there may be a significant overlap between a one model approach and a two-model approach in the types of contracts captured, the staff believe there would be differences because the one model approach attempts to approximate the

full building block model whereas a two-model approach would not be so constrained and would therefore apply to a wider range of contracts.

25. Therefore, the staff recommend that if the boards support a two-model approach for short duration contracts, the objective should be as follows:

    (a) To represent the characteristics of contracts for which a revenue recognition or allocation model in the pre-claims period is more appropriate, rather than provide a simplification or proxy for the building blocks approach.

Question 1 for the boards:
The staff recommend: 1) The objective of the premium allocation approach is to represent the characteristics of contracts for which a revenue recognition or allocation model in the pre-claims period is more appropriate, rather than provide a simplification or proxy for the building blocks approach. Do the boards agree with the staff recommendation?

What is an appropriate separate and distinct model?

26. If the boards agree with employing a separate and distinct model to account for particular short duration contracts, the next natural question to answer is which model would be appropriate. The staff believe there are three alternatives for possible models that could be applied. Those alternatives are as follows:

    (a) Alternative A – adoption of revenue recognition

    (b) Alternative B – current GAAP in many jurisdictions with targeted modifications

    (c) Alternative C – the premium allocation approach proposed in the ED with significant revisions to address concerns that respondents raised during the comment letter process with respect to over-engineering and cost/benefit considerations, eligibility, and permit vs. requiring the approach.

27. The table below compares each of the alternatives and the applicable accounting requirements for the pre-claims period. The staff provided a revised premium allocation approach based on our recommendations and analysis in paragraphs 32-123. The staff provided the premium allocation approach as proposed in the ED as part of the overview memo at agenda paper 8A/71A for the boards' comparison.

	Revenue Recognition Project	**Current GAAP (unearned premium) Approach**	**Revised Modified Measurement Approach**
Eligibility for premium allocation approach	N/A	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.	Staff recommendation (see analysis in paragraphs 32-65): A portfolio of insurance contracts are eligible for the premium allocation approach if all the following conditions are met: 1)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 2)the period of time between premium receipt and the date of loss is insignificant 3)the pricing of the premiums does not include risks relating to future renewal periods

Insurance liability in the pre-claims period at initial recognition. See next row for revenue recognition.	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	Unearned premium reserve equal to premiums charged for the unexpired coverage period	Staff recommendation (see analysis in paragraphs 66-89): An insurer should include in the measurement of the liability for remaining coverage at initial recognition 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.
Revenue recognition during the preclaims period	For services – as performance obligation is satisfied (similar to Insurance) For goods – when customer obtains control of good	Recognized in proportion to the protection provided	Staff recommendation (decision reached at the April 27 2011 joint meeting)): The insurer should reduce the measurement of the liability for remaining coverage over the coverage period as follows: 1) On the basis of time, but 2) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

Alternative A – Adoption of revenue recognition

28. While a wholesale adoption of the revenue recognition model may seem appropriate for short duration contracts given that some of the concepts appear to apply to the pre-claims period for short duration contracts, the staff do not believe

that this option is the most appropriate. We believe that adopting the revenue recognition model in totality could have unintended consequences in the following areas:

(a) the revenue recognition model is applied at the contract level as opposed to the portfolio level,

(b) the revenue recognition model contains requirements for discounting in some cases that:

  (i) may not be appropriate for the pre-claims period, or

  (ii) do not meet a cost/benefit test for insurance contracts

(c) deferred acquisition costs are accounted for as an asset under the revenue recognition model

29. Although the staff does not believe that a wholesale adoption of the revenue recognition model would be appropriate, we do believe there are concepts from revenue recognition that can be examined and used as potential revisions to the premium allocation approach, similar to analogizing to and using concepts from any other standard.

Alternative B

30. While alternatives B and C initially appeared to be separate alternatives, the staff believe the revisions to the premium allocation approach in the ED suggested as part of our recommendations in paragraphs 32-123 result in materially similar answers to current GAAP in many jurisdictions with targeted modifications. Furthermore, given the lack of guidance that currently exists for the unearned premium approach across all jurisdictions, the staff did not believe it was appropriate to carry forward current GAAP in this area without a full examination (including the post-claim period). While the staff acknowledges that current GAAP may be "well understood" in general in most jurisdictions as commented on by several respondents to the ED, the staff believe the development of a robust model that will be consistently applied across all jurisdictions is more appropriate, rather than applying practice that has evolved over time.

Alternative C

31. Therefore, we have concentrated the bulk of this discussion on revisions to the premium allocation approach as proposed in the ED, with a two-fold objective:

    (a) Simplify the premium allocation 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.

Question 2 for the boards:
The staff recommend: 2) The objective of revising the premium allocation approach should be two-fold: (a) Simplify the premium allocation 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. Do the boards agree with the staff recommendation?

Eligibility requirements under a two-model approach

32. The staff believe the most important issue to address from respondents' concerns is the eligibility requirements. As stated previously, a two-model approach could have an influence on the determination of the eligibility criteria. For example, if the boards conclude the premium allocation approach should be a simplification of the building blocks approach, presumably the eligibility criteria would encompass a narrower range of contracts as the criteria would naturally be restricted because the approach would serve as a sufficient proxy for the full building block model whereas a two-model approach would not have this constraint.

33. Some staff believe this constraint could significantly prohibit the types of contracts captured. Under a one model approach, at initial recognition, the liability for remaining coverage and the insurance contract liability determined under the building block approach would be the same for all insurance contracts, regardless

of the type. However, in order to be a sufficient proxy, it is likely that the coverage period would need to be limited to a period such that there would be minimal changes in expected cash flow for the portfolio of contracts because any changes in expected cash flows would result in differences between the two models. Some staff believe, that regardless of the eligibility criteria, it would be unreasonable to base a model on a presumption that there would be minimal changes in expected cash flows from the inception of the contract through the pre-claims period without having to perform a test to determine if the changes became something more than minimal. These staff believe the test would be more than an onerous contract test on a qualitative basis.

34. Agenda paper 8B/71B establishes the eligibility criteria if the boards determine the premium allocation approach is a single model or simplification of the building block approach.

Proposals in the ED

35. 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 […].

Relevant comments received

36. Many respondents, in particular property / casualty and health preparers, expressed opposition to the approximately one year or less eligibility restriction for the premium allocation 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. They are concerned the proposal will result in different accounting for similar products with different terms because they share similar economic characteristics with one-year contracts.

37. 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 any final guidance issued.

38. Other than applying current GAAP, respondents offered several suggestions for establishing eligibility criteria for the premium allocation approach, including:

    (a) a coverage duration longer than provided for in the ED (eg 3 years) (paragraphs 43-45),

    (b) the type of risk covered (paragraphs 46-50),

    (c) a homogeneous or "exhaustive search" concept (paragraphs 51-54),

    (d) the primary purpose of the contract (eg. providing risk protection) (paragraphs 55-56),

    (e) the significance of investment income potential over the coverage period (paragraphs 57-59),

    (f) the significance of the period of time between premium receipt and date of loss (paragraphs 57-59), or

    (g) consistency with contract boundary principles (paragraphs 60-63)

Analysis

39. The above list of suggestions should not be considered an all inclusive list but rather the most prominent or potentially workable solutions suggested. While the staff welcome all suggestions, we do believe that some items listed above are not workable while others can be combined to result in what we believe to be appropriate criteria. We first examined those items that we believe to be unworkable or not applicable.

Current US GAAP

40. Many respondents suggested using the current US GAAP guidance to define duration and thus the contracts eligible for the premium allocation 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.

41. 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.

42. While using the current definition of short duration contracts 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 viewed 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 that stipulates the contract enables the insurer to cancel the contract or adjust the provisions of the contract at the end of any contract period 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.

Duration

43. The staff then examined the possibility of using a different coverage duration than that provided for in the ED. 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 are still considered by some as short duration in Appendix A.

44. When examining the examples provided in Appendix A, the staff determined numerous issues may arise when the duration of coverage is used as the eligibility criterion. Those issues include:

    (a) 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) establishing bright line tests could create an opportunity to engage in accounting arbitrage whereby insurers could create contracts with specific duration periods, although the substance of the contract would be the same as today

45. Given these potential issues, the staff concluded that the use of any specific coverage duration is arbitrary and would not be sufficient to determine a contract's eligibility for using the premium allocation approach.

Type of risk

46. Several suggestions described a concept based on the type of insurance risk. This approach was likely suggested because many insurance contracts are accounted for by the types of risk(s) covered. The staff began 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.

47. 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 premium allocation approach.

48. The staff then considered whether only contracts with particular risks could be included to determine eligibility for the premium allocation approach. However, the staff concluded this approach could result in accounting arbitrage because it is possible to structure a contract to include or exclude particular risk coverage to avoid or obtain the desired accounting. Additionally, the boards would potentially need to re-visit the guidance in the future as new products are developed.

49. Finally, the staff considered whether contracts that cover particular risks could be excluded from eligibility for the premium allocation approach. For example, excluding mortality risk would prohibit the premium allocation approach for life insurance contracts. While this may appear to be a simpler 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.

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

A homogeneous or exhaustive search concept

51. Some respondents suggested that the eligibility criteria as proposed in the ED could be made workable if the insurer were allowed to determine at a portfolio level:

    (a) that an insignificant portion of the individual contracts comprising the portfolio were not in compliance, or

    (b) the number of contracts out of compliance with the eligibility requirements was an immaterial portion of the entity's business

    If the entity could determine either criterion, the entity would then be permitted to use the premium allocation approach for the entire portfolio.

52. While the staff believe this suggestion may be viable if the boards concluded that the premium allocation approach was a simplification or proxy for the building blocks model, we believe there are unresolved issues with this suggestion that would need to be addressed to make it workable. For instance:

    (a) this suggestion appears to be more of a materiality requirement than an eligibility requirement

    (b) what criteria is judged as insignificant or out of compliance? (eg. the time frame, the embedded options, or both)

    (c) what if the smaller percentage of contracts were life contracts? Did the boards intend for long duration life contracts to be accounted for under the premium allocation approach if the number of the contracts is immaterial?

53. The premise of a two-model approach is to capture those contracts that are fundamentally different in the pre-claims period. Therefore, we do not believe this

criterion would be necessary given that contracts managed differently would presumably not be in the same portfolio.

54. Although the staff found suggestions (a), (b), and (c) to not be viable options for eligibility criteria, we believe that suggestions (d), (e), (f), and (g) above could offer potential solutions. We have examined each of the suggestions in turn.

Purpose of the contract

55. While the staff acknowledge that all insurance contracts provide "risk protection", we do not believe that the intent of the suggestion provided in (d) [the primary purpose of the contract] was meant as general insurance risk (encompassing all contracts) or a specific type of risk (as discussed and dismissed in the section above), but rather the primary purpose of the contract is to solely provide for risk protection in which the ultimate outcome is unknown until incurred (ie. the event may never happen) and the ultimate payout can vary significantly in frequency and severity. Consequently, the compensation to the policyholder is based on the amount of the incurred insured loss (variable up to the amount of the policy limit) versus a specified amount in the contract.

56. The staff concluded earlier that these reasons drive the difference in the performance metrics for these contracts. We also believe these differences can be used to define eligibility requirements for use of the premium allocation approach. Therefore, the staff recommend that one of the criterion for determining if a portfolio of contracts is eligible for the premium allocation approach should be:

    (a) 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

Investment timing and potential for income

57. While option (e) [the significance of investment income] focuses on the significance of investment income over the coverage period, we believe the broader workable notion underpinning the suggestion is the amount of time (or lack thereof) for the overall investment strategy to make up for underwriting losses to fund these types of insurance contract obligations. This option, when combined with option (f) [the significance of the period of time between premium receipt

and date of loss], forms another eligibility criterion that highlights the short-term nature of the investments thereby placing the primary focus on underwriting.

58. As discussed above, the management strategy for shorter duration contracts primarily focuses on combined loss ratios and claims development (underwriting) with asset and liability management (investment management) as a secondary concern. This strategy is a function of the shorter duration of the contract due to the fundamental differences in the risks covered that drives the purpose of the contract. The shorter duration, by definition, does not allow time for investment income to make up for potential losses due to underwriting. Consequently, the investment strategy for short duration contracts is primarily one of liquidity management because of the uncertainty in the amount and timing of the payout. Liquidity management in this context means the investment strategy is to invest over a shorter time horizon, in highly liquid assets, in order to have the ability to fund liabilities that could come due immediately.

59. The staff believe the differences described above are one of the reasons why there is a fundamental difference in what we have referred to as short duration (non-life type) contracts and we believe this difference can be used as one of the criterion that must be met to use the premium allocation approach. Therefore, the staff recommend that one of the criterion to determine if a portfolio of contracts is eligible for the premium allocation approach should be:

   (a) the period of time between premium receipt and the date of loss is insignificant

Pricing of future renewals

60. The staff believes the suggestion expressed in (g) above [consistency with contract boundary principles] contemplates the ability of the insurer to re-price and re-underwrite the contract thereby including in the eligibility requirements for the premium allocation approach the principles of contract boundaries.

61. At the March 2011 meeting the boards tentatively decided:

   (a) Contract renewals should be treated as a new contract:

      (i) When the insurer is no longer required to provide coverage; or

(ii) When the existing contract does not confer any substantive rights on the policyholder.

(b) A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

(c) For contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio that the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.

62. The staff believes it is consistent to include the concept of the ability to re-price future risks as part of the eligibility requirements for the premium allocation approach. We believe this because it is consistent with depicting the difference between an underwriting strategy and an investment management strategy which is one of the fundamental differences in the contracts we are attempting to capture.

63. For those contracts that primarily focus on an underwriting strategy, it is important that the pricing of the premium is sufficient to cover the potential losses. As stated previously, the short term nature of these contracts do not allow time for significant investment income to overcome potential underwriting losses. For these types of contracts, profitability issues are addressed through re-pricing and re-underwriting. Thus, the pricing of contracts that are primarily managed using an underwriting strategy should not contemplate future renewals in the same manner longer duration contracts would. Therefore, the staff recommend that one of the criterion to determine if a portfolio of contracts is eligible for the premium allocation approach should be:

(a) the pricing of the premiums does not include risks relating to future renewal periods

Staff Recommendation

64. The staff believes the analysis above proves there are fundamental differences with contracts that are of a short duration (non-life type) and the requirements developed capture the characteristics of those contracts (which affects the primary

performance indicators and drives the management of those contracts) to determine eligibility for the premium allocation approach which we believe to be a separate and distinct model that should not be constrained by a building block proxy notion.

65. Therefore, based on the analysis above, the staff recommend that a portfolio of insurance contracts is eligible for the premium allocation approach if all the following conditions are met:

    (a) 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

    (b) the period of time between premium receipt and the date of loss is insignificant

    (c) the pricing of the premiums does not include risks relating to future renewal periods

Question 3 for the boards:

The staff recommend:

3) A portfolio of insurance contracts are eligible for the premium allocation approach if all the following conditions are met:

   a. 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

   b. the period of time between premium receipt and the date of loss is insignificant

   c. the pricing of the premiums does not include risks relating to future renewal periods

Do the boards agree with the staff recommendation?

Discounting of the liability for remaining coverage

Proposals in the ED

66. 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.

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

68. 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.

69. 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

70. At the February 17, 2011 meeting, the Boards tentatively approved a set of axioms. These axioms 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.

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

Relevant comments received

72. Most 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.

73. Respondents often compared the premium allocation approach proposed in the ED to the unearned premium reserve approach that is used in many jurisdictions. The discounting for premiums was viewed as the most significant departure from the

current approach and respondents felt the costs of discounting outweighed the benefits that would be gained.

Analysis

74. The staff considered whether the measurement of the liability for remaining coverage at initial recognition should:

    (a) consider the time value of money and therefore discount the future premiums and accrete interest, or

    (b) use the nominal value of future premiums

75. 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. However, the staff that believe the premium allocation approach is a separate and distinct model do not believe the model necessarily has to adhere to all elements of the building block approach given the respondents concerns we are trying to address.

76. The staff believe the issue of discounting may arise in two areas:

    (a) for future premiums that have not yet been received, and

    (b) for premiums that have been received but not yet earned.

Future premiums not yet received

77. In the premium allocation approach, because the measurement of the liability for remaining coverage is a function of the premiums received plus the expected present value of future premiums, the accretion of interest on the liability for remaining coverage is offset in the same period by the amortization of interest on the premiums receivable.

78. In addition to the income statement effects netting to zero it is also important to consider the usefulness of the 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 liabilities. Based on this paragraph, the future premiums receivable would be netted with the liability. While the staff acknowledges the roll forward of balances included in the footnotes could show the amounts separately, it would not be

transparent to the users of the financial statements whether the future premiums are discounted and accreted from the face financials.

79. Although several respondents suggested recording the liability for remaining coverage separately from the receivable, the staff are not convinced the impact of discounting the balance sheet for the liability for remaining coverage 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. The staff will consider the presentation of the statement of financial position at a future meeting.

80. Given the analysis above, the staff does not believe that discounting future premiums not yet received provides decision useful information. While discounting in this instance may be the conceptually correct answer, given the lack of decision useful information because of the offsetting impact (on the liability for remaining coverage and the receivable), the staff does not believe the benefits of such an approach would outweigh the costs to implement.

Premiums received but not yet earned

81. In some instances, an insurer may receive the entire amount of the premium at initial recognition of the contract. In this instance, the cash received can be invested (and income earned) without a corresponding offset for accretion of interest for the liability for remaining coverage effectively making the insurer appear to be more profitable on an interim basis.

82. The recent decisions in the revenue recognition project included the following:

    (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.

83. The staff believe that the first criterion in (a)(i) of the preceding paragraph could be relevant to insurance accounting. The criterion could be significant if an insurer charged a policyholder a fee[2] 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 pre-claims period and the ultimate amount of the pre-claims obligation. However, the staff believe this criteria is directly tied to the expected future premiums as presumably the financing would attach to those premiums given that the policyholder would be charged more to pay over time. As discussed above, we do not believe discounting future premiums that have yet to be received provides useful information.

84. The staff believe that the second criterion in (a)(ii) above is not directly relevant to insurance accounting. In the case of insurance, if the policyholder does not pay their premium, the policy will lapse and no coverage is provided. However, some could argue that the criterion could relate to insurance if the timing difference between receipt of initial premium and the coverage period provided was considered. This timing difference could be an indicator that the insurance contract includes a significant financing element. While this may be true, the staff do not believe this is relevant given that if the policyholder were to cancel the contract, the insurer would owe the policyholder the unearned amount from what was initially paid without regard to interest earned on the cash received and if the policyholder does not pay, the insurer would no longer have an obligation.

85. Additionally, discounting cash amounts received up front adds an element of complexity to the model that, in the staff's opinion is unwarranted. The ultimate amount of revenue earned will always be the initial cash received and expected. The uncertainty lies with the ultimate amount of the claims that will be incurred.

[2] There is diversity in practice. In the US, typically there is no fee or it is nominal, such as $6, to cover processing costs. In the UK there are certain contracts that charge a percentage of the premium, i.e., 10% as a fee.

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

87. When considering the concern above and 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:

    (a) discounting future premiums that have not yet been received does not provide decision useful information,

    (b) if the policyholder were to cancel the contract, the insurer would owe the policyholder what was initially paid without regard to interest earned on the cash received (ie. the nominal amount)

    (c) if the policyholder does not pay the premium when due, (typically when the insurance coverage is provided), the policy lapses and the insurer would no longer have an obligation,

    (d) discounting these amounts adds complexity to the pre-claims period accounting that is unwarranted given the amount earned will always be the cash received and expected all things held equal.

Staff Recommendation

88. 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 premium allocation approach. Accreting interest for contracts that apply the premium allocation approach adds a layer of unnecessary complexity and will likely add costs that do not outweigh the benefits.

89. Therefore the staff recommend an insurer include in the measurement of the pre-claims obligation at initial recognition 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.

Question 4 for the boards:
The staff recommend: 4) An insurer include in the measurement of the pre-claims obligation at initial recognition 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. Do the boards agree with the staff recommendation?

Treatment of deferred acquisition costs

Proposals in the ED

90. 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.

91. Paragraph 75 of the ED proposes that for contracts measured using the premium allocation 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.

92. 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

93. 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.

94. During the June 13, 2011 meeting the boards tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of

insurance contracts should be all of the direct costs that the insurer will incur in acquiring the contracts in the portfolio such as:

(a) Direct costs of contract acquisition/origination.

(b) Portion of employee's total compensation and payroll-related fringe benefits related directly to time spent performing any of the following activities:

    (i) Underwriting

    (ii) Policy issuance and processing

    (iii) Medical and inspection

    (iv) Sales force contract selling.

(c) Costs directly related to the activities in (2).

(d) Direct response advertising.

95. The FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to those costs related to successful acquisition efforts. The IASB tentatively decided that no distinction should be made between successful acquisition efforts and unsuccessful efforts.

Relevant comments received

96. 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.

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

Analysis

98. The staff considered whether insurers should be required to reduce the liability for remaining coverage 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) some of the acquisition costs that would qualify to be included in the amount that would reduce the pre-claims liability (ie. permit immediate expense of particular cost)

99. The staff believes there are two alternatives for proceeding with the accounting for acquisition costs under the premium allocation approach:

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

(b) Alternative 2 – permit or require entities to expense particular acquisition costs

100. 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 premium allocation 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.

101. However, 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 premium allocation 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.

102. Furthermore, the boards recently tentatively decided in the revenue recognition project, that as a practical expedient, an entity is permitted to recognize the incremental costs of obtaining a contract as an expense when incurred for contracts with a duration of one year or less.

103. 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. Including the acquisition costs that would otherwise qualify to be included as part of the expected cash flow as a reduction of the liability for remaining coverage is consistent with the building block approach, the recent decision by the IASB in April with regard to this matter, and brings the boards closer to a converged solution. Therefore, the staff find no compelling reason to present acquisition costs differently for contracts under the premium allocation approach. Information regarding the amount of deferred acquisition costs and the amortization thereof that users find helpful in assessing an insurance company will be provided in the roll-forward of the liability for remaining coverage as well as the amortization of the deferred acquisition costs in the statement of comprehensive income.

Staff Recommendation

104. Based on the factors above,

Questions 5, 6 and 7 for the boards:

The staff recommend:

5) The boards reconfirm the liability for remaining coverage should be measured net of acquisition costs.
6) An insurer is permitted to expense particular internal direct acquisition costs that otherwise meet the criteria as set out in the most recent tentative decisions made by the IASB and the FASB.
7) An insurer is required to disclose which acquisition costs are included in the liability for remaining coverage.

Do the boards agree with the staff recommendations?

Components of an onerous contract test

Proposals in the ED

105. 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.

Relevant comments received

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

107. 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.

108. Several respondents proposed developing qualitative criteria to determine if an onerous contract test should be performed. This will improve the flexibility of the premium allocation 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.

Analysis

109. The staff believe the purpose of an onerous contract test is to determine the amount by which the expected present value of cash flows (i.e., claims, claim adjustment expenses, policyholder dividends, unamortized acquisition costs, and maintenance costs (including unpaid commissions))exceeds the related unearned premium (including any future installment premiums).

110. 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 in some or all of those jurisdictions considers some or all anticipated investment income as a factor in the test.

111. The boards tentatively decided that an insurance contract liability under the building block approach should be measured as the expected present value of the 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 included in the expected cash flows, but the time value of money would be included in determining the expected present value of cash flows. Therefore, the staff believe the onerous contract test should be performed using the present value of the expected cash flows.

112. 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). At the May 2011 meetingthe IASB tentatively decided to include a risk adjustment while the FASB tentatively decided on a single margin approach.

113. Feedback from respondents indicated that including a risk adjustment in the onerous contract test could result in recording losses for contracts that are ultimately profitable. These respondents 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. The staff believe that determining a contract is in a loss position based on the expected cash flow plus what some consider to be a portion of expected profit that is at risk (risk adjustment or a single margin) would be unduly burdensome.

114. In the revenue recognition project, the boards tentatively decided that the costs an entity should consider when applying the onerous test are the lower of:

    (a) The costs that relate directly to satisfying the performance obligation (defined in paragraph 58 of the Exposure Draft), and

    (b) Any amounts the entity would have to pay to cancel the contract.

    No risk adjustment is included although the costs to fulfill the obligation may not yet be known, especially on large customized contracts.

115. The staff believe the above decision is relevant given that we believe the premium allocation approach is a separate model that is more akin to revenue recognition or an allocation approach and we view any differences between premium and cash outflows as potential profit at risk whether as a single margin or a risk adjustment. Therefore, we do not believe that it would be appropriate to recognize a loss on a potentially profitable contract simply because the cash flows may be uncertain.

116. Finally, while the staff acknowledges the concerns expressed by respondents about calculation of an onerous test at the cohort level, we will consider this concern in a future paper on the definition of a portfolio.

Staff Recommendation

117. The staff recommend that an onerous test should not include a risk adjustment and therefore an additional liability should be recognized if the carrying amount of the pre-claims obligation expected is less than the present value of the cash outflows, with no risk adjustment.

Question 8 for the boards:
The staff recommend: 8) An additional liability should be recognized if the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation. Do the boards agree with the staff recommendation?

Permit versus require

Proposals in the ED

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

Relevant comments received

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

120. Some responded that for comparability a premium allocation approach should be required for all contracts that meet the eligibility criteria.

Analysis

121. The results from the building block approach and the premium allocation approach will not be the same. However, the staff acknowledge that some insurers 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.

Staff Recommendation

122. Some 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 premium allocation approach.

123. Other staff believe that because the contracts that meet the requirements of the premium allocation approach as analyzed in this paper are fundamentally different from those that do not, the premium allocation approach should be required for those contracts. Disclosures are not a substitute for presentation on the face of the financial statements.

Question 9 for the boards:
9) Some staff recommend permitting the premium allocation approach for those contracts that meet the eligibility criteria. 10) Some staff recommend requiring the premium allocation approach for those contracts that meet the eligibility criteria. Which staff recommendation do the boards support?

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 in a business combination, in which an acquiring entity will write longer coverages to align the effective dates with their existing blocks of business
5. 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
6. Satellite business which covers the period of time from launch through duration of orbiting
7. 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
8. 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