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Project	**Insurance Contracts**
Topic	**Premium Allocation Approach: Eligibility Criteria**

Purpose of the paper

1. On July 21st 2011, the boards discussed, without conclusion, whether the premium allocation approach constitutes a separate and distinct model of accounting for insurance contracts or whether it should be used only when it is a proxy for the building block approach. This paper responds to suggestions in that meeting that we should not focus on that distinction, but instead focus on determining eligibility criteria for application of the premium allocation approach. For the purposes of this paper, we consider the eligibility criteria by considering what features in a contract mean that a premium allocation approach does not provide sufficiently useful information to users of financial statements, and what features in a contract would make it too difficult to apply the premium allocation approach.

2. This paper does not address the specific mechanics of the premium allocation approach (e.g. the use of discounting, inclusion of a risk adjustment in the onerous test, treatment of deferred acquisition costs, etc.). We will discuss those mechanics in a future meeting. This paper also does not discuss whether insurers should be permitted, rather than required, to apply the premium allocation approach to contracts that meet the eligibility criteria recommended by the staff.

Summary of staff recommendations

3. The staff recommends that insurers should apply the building block approach rather than the premium allocation approach to portfolios of contracts when either of the following apply:

   (a) the building block approach provides more relevant information for these portfolios than the premium allocation approach, relative to the cost of providing that information. This might be the case if the portfolio of contracts have either of the following features:

      (i) The expected cash flows before the claim is incurred are expected to vary significantly over the coverage period (for example, the contract contains options and guarantees that significantly affect the variability of cash flows based on changes in market factors) and such variance is not expected to result in recognition of an onerous contract adjustment; and

      (ii) (for the IASB) the risk in the contract associated with the liability for remaining coverage has the potential to vary significantly.

   (b) it is difficult to allocate the premium for the contract in a reliable and rational manner. This might be the case in any of the following circumstances:

      (i) It is difficult to determine the amount of the premium to allocate to reporting periods, for example because the contract contains significant deposit elements that are not unbundled.

      (ii) There is significant uncertainty about the length of the coverage period, for example because the contract includes options for renewal.

      (iii) It is difficult to identify and separate the insurers' obligations to the policyholder arising from the contract, for example contracts where the expected payments to policyholders are affected by complex interdependent options.

4. In addition, some staff further recommend that, for portfolios of contracts in which most of the contracts' coverage periods are approximately one year or less, insurers should always be permitted to measure the liability for remaining coverage using the premium allocation approach as a proxy for the full building block approach.

Background

Tentative decisions reached to date on the premium allocation approach

5. The boards have reached two tentative decisions that are relevant to determining eligibility requirements for application of the premium allocation approach:

   (a) that an insurer should reduce the measurement of the liability for remaining coverage over the coverage period (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. This decision is consistent with the proposed revenue recognition standard.

   (b) that premium revenue (based on the release of the liability for remaining coverage grossed up for amortization of acquisition costs) should be disclosed on the statement of comprehensive income. (Agenda paper 4D/74D discusses the presentation of the statement of comprehensive income.)

Premium allocation approach proposed in the Exposure Draft

6. An insurance contract liability has two components: (a) a liability for remaining coverage and (b) a liability for incurred claims. In the building block approach, both the liability for remaining coverage and the liability for incurred claims are measured in the same way, ie on the basis of the expected future cash flows that will arise as the insurer fulfils the contract. However, the IASB developed the premium allocation approach as a means of simplifying the building block approach, as paragraphs BC145 and BC146 of the exposure draft explained:

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. *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.*

7. Thus, the premium allocation approach proposed in the ED simplifies the measurement of the insurance contract liability by simplifying the measurement of one component of the insurance contract: the liability for remaining coverage. Instead of estimating that liability using updated estimates of the expected cash flows, discount rate, risk adjustment and residual margin, it estimates it by reference to the premium at inception.

Differences between informational demands of users of life insurance and non-life insurance financial statements

8. Many preparers and users stated that significant differences exist between life and non-life insurance contracts and that this means that different information is needed to perform the different types of analyses needed for these products.

9. Generally speaking, non-life insurance analysts seek to identify trends in frequency and severity of losses and the relative quality of underwriting. They achieve this by a focus on the underwriting results through:

(a) Ratios, such as the loss ratio (i.e., losses incurred divided by premiums earned) and related development in the historical loss reserves. Such analysis is facilitated through information about the claims incurred (both reported claims and incurred but not reported claims), and premium earned in the reporting period.

(b) Development in the historical loss reserves. The primary tools to assess historical loss reserves are the loss development tables, including those included in non-GAAP regulatory filings[1]. The loss development tables would be required, at some level of aggregation, in the disclosures proposed in the ED and should reconcile to the information on the face of the financial statements.

10. On the other hand, life insurance analysts focused more attention on estimates of investment income over the life of the portfolio, the effectiveness of asset-liability matching, and the sensitivity of their products to changes in mortality, discount rates, and lapses/persistency rates. Accordingly, those analysts place much value on current estimates of those variables in determining the liability for remaining coverage, compared to non-life insurance analysts. This is due to the fact that, for non-life contracts, there is relatively more significant risk in the liability for remaining coverage compared to the liability for incurred claims. (For life contracts, there is little to no risk subsequent to the date of the insured event, whereas settlement risk, for example due to litigation, is a significant driver of many non-life insurance contracts' uncertainty following an insured event). In addition, the short duration of the pre-claims period for non-life contracts means there is implicitly less time on average for events to occur subsequent to pricing that will result in a change in estimates and there is less time before the updated estimates are recognized as incurred losses.

[1] U.S. regulatory filings disaggregates the loss development data into over a dozen schedules by line of business/product types which gives users more detailed information for analysis.

Staff Analysis

11. The liability for remaining coverage, under the mechanics of the premium allocation approach, is similar to the Unearned Premium Reserve 'UPR'[2]. The UPR 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 widely used for short duration contracts in many countries today. Both the UPR and the premium allocation approaches have some similarities to the allocated transaction price approach used in revenue recognition. That makes the premium allocation approach intuitively understandable and easily applicable for some types of contracts. Many preparers and users state that it is important to analyse non-life insurance contracts by considering premium revenue and claims and claims adjustment expenses.

The UPR approach in US GAAP

12. Many respondents (particularly property/casualty and health preparers) commented that they wanted to maintain the existing unearned premium approach in US GAAP for non-life contracts, as users find it useful. Many respondents think that current standards and practice successfully distinguish between longer term contracts and those that are accounted for using the unearned premium approach in current US GAAP and other local GAAP.

13. The staff evaluated if areas of divergence in practice exist in classifying contracts to assess whether the concepts in the definition are in fact commonly understood in practice, as respondents indicated. The view that difficulties do not exist for classifying contracts is supported by staff outreach, which indicates that divergence today exists only for the classification of 'lost instrument

[2] The UPR is a premium allocation approach that apportions the total premiums received between the earned and unearned components. The effect of the time value of money is generally not considered. When applying the UPR approach, insurers present acquisition costs as an asset and perform an explicit onerous contract test only if there are indications that a portfolio has become onerous. They typically measure onerous contract liabilities without including a risk adjustment.

insurance'[3]. These contracts are believed to represent only a very small percentage of non-life contracts.

14. The staff observed that in some jurisdictions, classification of contracts is based on regulatory determinations and not the definition in Topic 944, but that such regulations typically yield classification results consistent with the unearned premium approach for non-life contracts in current US GAAP. Although the staff did not identify other contracts where differences exist today, we found no evidence of widespread diversity in classifying contracts.

15. Some respondents (mainly from the US) suggested using US GAAP to define the contracts eligible for the premium allocation approach because the concepts in that definition are commonly understood in practice. However, some respondents view the language in US GAAP as circular and not particularly helpful in assessing whether a contract's duration should be deemed short relative to another. That said, because the staff agrees with respondents' concerns regarding the current definition of short duration contracts provided by US GAAP, we think it is not a preferable alternative for an eligibility criterion.

Focus on eligibility for premium allocation approach or for building block approach?

16. The staff believe that some features or characteristics of contracts could distinguish between the contracts to which an insurer should apply the building block approach, and those to which an insurer should apply the premium allocation approach. Said differently, looking at the differences in outcomes when applying one approach as opposed to the other may be helpful in determining which approach should apply to which contracts.

17. In previous discussions, the staff have assumed that the building block approach is the default measurement model for all insurance contracts and tried to justify a departure from the building block approach for some types of contracts. In the

[3] 'Lost instrument insurance' provides assurance when an individual loses a certificate for a stock, bond, or other negotiable instrument. In those cases, lost instrument insurance must be filed with the transfer agent/issuer of the asset before replacement securities may be issued to the registered owner. Lost instrument insurance protects the transfer agent from the liability that would result in the event that the lost securities were to reappear and be renegotiated. Property and casualty insurers that issue commercial surety insurance are the primary issuers of lost instrument insurance.

one-model view, the justification was on the grounds of simplification. In the two-model view, the justification was on the grounds of different characteristics and substantive economic differences between the two types of contracts. However, that process has generated intense discussion about the merits of a one-model approach or a two-model approach. For the purposes of this paper, and in an attempt to find common ground, we reverse the analysis and instead consider what features in a contract mean that a premium allocation approach does not provide sufficiently useful information to users of financial statements and what features in a contract would make it too difficult to apply the premium allocation approach[4].

Differences between the premium allocation and building block approaches

18. The premium allocation approach is consistent with the accruals basis of accounting in that the premium allocation approach:

    (a) recognizes premiums as revenue in the period when the insurer provides related coverage.

    (b) recognizes claims in the period when those claims are incurred, and, thus, in the same period as the premium revenue attributed to the coverage that gave rise to those claims.

19. In contrast to the building block approach (for which the outcome is difficult to reconcile to revenue and expense information), the premium allocation approach also generates premium revenue and expense information. As noted in paragraphs 8-10, many users think that premium and claim information are the basis for the key metrics needed to analyse insurance contracts and this information is provided by the premium allocation approach, and not the building block approach. Providing this information is also consistent with the proposed revenue recognition standard and thus consistent with information in the financial statements of entities in other industries. We further discuss the

[4] In light of the change in approach described in the previous paragraph, the staff also reconsidered respondent feedback, which has been presented to the boards in previous papers. This feedback is included in Appendix A.

usefulness of disaggregating that information in the financial statements in agenda papers 4C/74C and 4D/74D.

20. The primary differences[5] between the premium allocation approach (as proposed in the ED, and modified by the boards' subsequent tentative decisions) and the building block approach are that under the premium allocation approach:

    (a) the measurement of the liability for remaining coverage would not routinely be updated to reflect changes in estimates of future claims or risk. However, an onerous contract test would be applied when facts and circumstances indicate that contracts have become onerous in the coverage period. This mitigates the measurement differences between the approaches.

    (b) The premium allocation approach naturally generates premium revenue and claims expense information.[6]

21. The measurement difference in paragraph 20(a) means:

    (a) The estimate of the liability is not updated when circumstances improve, i.e. the "upside" is not considered. Thus the approach is more conservative than one which updates the estimate of the liability to reflect favourable changes in circumstances.

    (b) The full effect of a deterioration in estimates is not always reflected. This would occur when cash flow (and risk adjustment estimates under the IASB's model) deteriorate without triggering the onerous contract test.

22. These differences would exist only for the liability for remaining coverage. For claims incurred during the coverage period, the IASB has tentatively decided that the building block approach applies (i.e. that the liability for incurred claims is measured as the present value of the unbiased expected cash flows [statistical

[5] The boards have had an incomplete discussion of the changes to make to the premium allocation approach proposed in the ED. We will discuss those changes and confirm previous tentative decisions in a future meeting.

[6] In the statement of comprehensive income presentation for contracts measured under the premium allocation approach, premium revenue is recognized as coverage is provided and claims and claims adjustment expenses are matched against this earned premium whereas this revenue and matched expense are not presented for contracts measured under the building block approach.

mean], adjusted for risk), whereas the FASB tentatively decided that the liability for incurred claims should be measured as the present value of the unbiased expected cash flows [statistical mean] without a single margin.

23. The measurement difference in paragraph 20(a) means that the cost of applying the premium allocation approach can be significantly lower than the cost of applying the building block approach. Therefore, when the premium allocation approach provides sufficient information to users of financial statements, the benefits of applying a building block approach may not be justified relative to the cost. The benefit of the building block approach, ie the usefulness of information that arises when the estimate of the liability is continuously updated with more current information, would be sufficient to justify the costs for those contracts only when insurers expect significant variation in the estimate of the liability for remaining coverage.

24. In addition, the presentation difference in paragraph 20(b) means that the premium allocation approach can provide the premiums revenue and claims information needed to determine the key performance metrics that are needed by users and preparers.

25. We discuss the eligibility criteria for the building block and premium allocation approaches by considering:

    (a) the circumstances in which the building block approach could provide better information to users of financial statements (paragraphs 26-35).

    (b) the contracts for which the premium allocation approach is not simpler to apply than the building block approach (paragraphs 37-46).

    (c) the interaction with presentation (paragraph 46).

    (d) whether there is any correlation between the factors above and the length of the coverage period (paragraph 47-53).

When does the building block approach provide more relevant information than the premium allocation approach?

26. Because the premium allocation approach does not include a routine requirement to forecast or risk-adjust the expected future claims, it only provides similar information to users of financial statements as the building block approach when there is little variation in the estimate of the liability for remaining coverage over the coverage period[7]. This would be the case:

    (a) When estimates of cash flows during the coverage period are unlikely to change significantly. (However, the staff also note that in the IASB's model, the tentative decision to adjust the residual margin for changes in expected cash flows means that the total insurance liability would not change for all changes in estimates of cash flows, and this would make the premium allocation approach more similar to the building block approach.)

    (b) (for the IASB) When the risk in the contract is not expected to vary during the coverage period. However, when risk increases, it may trigger an onerous contract test which would reduce the differences between the approaches, depending on the details of how the onerous contract is identified and measured.

27. The staff note that the effect of changes in estimates of cash flows could be significant or material to an insurer without triggering the onerous contract test. For example, in the case of directors' and officers' liability coverage, changes in the legal or economic environment could impact estimates of cash flows without triggering the onerous contract test. Essentially, for portfolios of contracts that would apply a single margin (if they were to be measured under the building block approach) under the FASB's tentative decisions, the magnitude of the profit estimated at inception represents the amount of the change that could exist before an onerous contract test is triggered under the premium allocation approach.

28. In addition, the lack of information if updated estimates are not provided because the premium allocation approach is applied should be balanced against

[7] Expectations of variability in the post-coverage period would be reflected in the liability for incurred claims under both the premium allocation and building block approaches.

the perceived benefit of information about premiums and claims that would be provided using the premium allocation approach.

Variability in estimates of cash flows in the liability for remaining coverage

29. For many portfolios of contracts there is unlikely to be any significant changes in the expected cash flows used to estimate the liability for remaining coverage. This would mean that there is unlikely to be a significant measurement difference in applying the two models. This is typically true for contracts sold in high volume with expected low severity and high frequency of insured events. However, for some portfolios of contracts the insurer's expectations of the cash flows needed to fulfil the contract may vary significantly during the coverage period and there would be more significant differences in applying the two models. This is more likely to be true for contracts with high severity and low frequency of insured events, but even for such contracts, there may be very little volatility prior to the loss being incurred. For example:

    (a) there is little advanced notice for an earthquake, airplane crash, or other severe events that occur without warning and thus there would be few changes in expectations of cash flows before the insured event occurs.

    (b) there is a little more advanced warning in the expected value of claims for hurricane insurance, and even more for directors and officers insurance whose estimates are impacted by changes in the economic and legal environment.

30. The premium allocation approach does not reflect changes in estimates unless contracts are onerous, therefore the premium allocation approach would capture high variability in cash flows only through the onerous contract test. That test would account for some significant 'down-side' variation (e.g. the sudden emergence of an impending catastrophe). However, the premium allocation approach would never capture significant potential for 'upside' changes in estimates or 'down-side' changes that are insufficient to trigger an onerous contract test (but might still be material).

31. In contrast, the building block approach requires a continuous re-measurement of estimates of cash flows, for both the liability for remaining coverage and the liability for incurred claims. Therefore, it would capture the situations where the cash flow estimates are more favourable than expected or not unfavourable enough to trigger an onerous contract test. Furthermore, because the onerous contract test would be performed only when indicated by facts and circumstances, and the amount of the liability may be determined less rigorously, the building block approach would capture more completely situations in which the cash flow estimates are less favourable than expected.[8]

32. Other features that could significantly affect the variability of estimates of cash flows during the coverage period are complex features, such as options, other derivatives and guarantees, each which could significantly affect the variability of estimates of cash flows for future claims. Those features increase the inherent uncertainty about the estimates of cash flows needed to fulfil the liability for remaining coverage and increase the value of the information provided by the building block approach. (Those features also make it difficult to apply the premium allocation approach, a topic which we discuss in paragraphs 37-44.)

33. We considered whether there was significant variability in expected cash flows for coverage for insured events that result in a quantified payment (e.g. a fixed amount if a specified event occurs), rather than coverage for insured events that result in payments that reimburse the policyholder up to a policy limit. However, although those differences could influence the certainty with which the insurer makes estimates of the expected cash flows, they do not result in a qualitative difference. As an example, for a 30 year life insurance contract with a fixed benefit whose terms call for annual premiums, the expected nominal cash outflow might be estimated with a relatively high degree of certainty. However, the timing of an insured event (if one should occur) creates variability in the cash flows due to the impact on the amount of premiums the insured is obligated to pay and due to the time value of money.

[8] However, we note that the IASB's decision that changes in estimates of cash flows should result in an equal and opposite adjustment to the residual margin means that the total insurance contract liability measured under the IASB's building block approach and the premium allocation approach would not differ.

Variability of risk (for the IASB)

34. The premium allocation approach, in effect, allocates the implicit risk factor related to the liability for remaining coverage that exists within the contract pricing / premium over the coverage period. This would be appropriate for those contracts for which the most significant factor in the release from risk is the passage of time, for example for many high volume, retail contracts.

35. However, for some contracts and in some situations, risk can vary significantly with new information that arises, for example catastrophe cover and directors' and officers' liability coverage. The building block approach requires a continuous re-measurement of risk and could provide better information for those contracts than the premium allocation approach.

36. We plan to consider for a future meeting whether the premium allocation approach should exclude risk adjustments from the identification and measurement of onerous contracts.

When is it too difficult to apply the premium allocation approach?

37. One of the reasons that the boards developed the building block approach is the difficulty in applying generally applicable requirements to some insurance contracts. It would not be difficult to apply the revenue recognition model to some types of insurance contracts. However there would be difficulties in doing so, for example for:

    (a) Contracts where the expected payments to policyholders are affected by complex interdependent options (e.g. for some types of guarantee),

    (b) Contracts that implicitly provide protection against a decline in insurability, and

    (c) Annuities.

38. For these contracts, the ED suggested that it is necessary to measure the liability on the basis of all the cash flows necessary to fulfil the insurance contract. This approach considers an insurance contract to be a bundle of rights and

obligations giving rise to a package of cash inflows and cash outflows. Paragraph BC39 of the exposure draft describes that some insurance contracts:

"...blend financial elements with service elements in various proportions, depending on the type of contract, and that those elements combine to generate a package of cash inflows and cash outflows.

Furthermore, the exposure draft also suggests that accounting for cash inflows separately from cash outflows would not faithfully represent the nature of the transaction:

Applying different approaches to contract rights and performance obligations amounts to an implicit assumption that the contract generates two separate streams of cash flows that are independent of each other. However, that is not the case for many insurance contracts.

39. Therefore, another reason to apply the building block approach, rather than the premium allocation approach, is because there are contracts in which practical difficulties arise in applying the premium allocation approach. This includes:

    (a) Contracts where it is difficult to allocate premiums in a rational manner, e.g.:

        (i) Where the pattern of satisfaction of the performance obligation is not straightforward, e.g. annuities or some contracts with an uncertain coverage period.

        (ii) Contracts with complex options that make it difficult to separate the performance obligations because the expected cash flows depend on the interaction of those options.

    (b) Contracts which have significant deposit elements that are not unbundled, and, therefore, it is difficult or arbitrary to identify the total revenue to be generated over the life of the contract.

Contracts where it is difficult to allocate the premium in a rational manner

40. A premium allocation approach is more appropriate when an insurer can allocate the premium in a rational manner. In other words, a premium allocation

approach can be easily applied when the performance obligations in the contract can be separated and revenue reliably allocated over the life of the contract.

41. Difficulties can arise as follows:

    (a) For many life contracts, the length of the coverage period is highly uncertain because the option for the policyholder to cease paying premiums during the contract term generates uncertainty in the period of time over which to allocate the premiums. In contrast, for many property and casualty contracts, the coverage period is fixed and thus the premium could be readily allocated over the coverage period. Although most property and casualty contracts are cancelable by the insured, the relatively shorter coverage period results in much less significance to the uncertainty.

    (b) For many contracts, the premium for the next period covers both the insurance cover in the next period and the option to buy insurance cover at a predetermined rate in future periods. For example, the premium in the first year of a 10 year life contracts includes insurance coverage for the first year, the option to buy insurance coverage for the second year, the option to buy insurance coverage for the third year if the policyholder pays the second year premium, etc. It would be complex to identify all those options and arbitrary to allocate the premium separately to each of them. In addition, such an exercise may not provide useful information.

42. Paragraphs BC20-BC32 of the Basis for Conclusions to the ED, reproduced in Appendix B, describe more fully cases for which it is difficult to apply the approach proposed in revenue recognition. In the staff's view, some of these difficulties also exist in applying the premium allocation approach.

Contracts Which Have a Significant Deposit Element

43. Many suggest that it might be difficult to apply the premium allocation approach to contracts with both a savings and risk component. For such products, the premium charged may be based on the expectations of investment returns to assist in covering the expected loss. In addition, it may be difficult to

identify the extent to which the premium reflects premiums paid for risk coverage (and thus represent revenue) and premiums that are expected to be repaid to the policyholder with a return (plus or minus some form of interest or other investment return) regardless of the occurrence of an insured event (referred to as 'deposit components'). These deposit components do not represent revenue and do not relate to any particular reporting period and therefore should not be allocated to reporting periods using the premium allocation approach. To the extent that deposit components are unbundled, this issue does not arise. However, the difficulties in identifying deposit components that are integrated with insurance components means that not all deposit components will be unbundled. Thus, difficulty arises in determination of the premium.

44. Integrated deposit components generate implicit investment returns and investment risk, and are likely to be significant to contracts:

    (a) When the period of time between premium receipt and expected date of claim payment is significant. A relatively long period of time between receipt of premium and any likely claim payment gives the insurer the opportunity to invest the premiums over a long period of time, so that the insurer's investment returns can mature to fund the contract obligation, or make up for potential underwriting losses. In this case, an insurer relies on investing premiums over time such that the premiums plus investment returns will cover claims (in addition to provide for the policyholder return on the deposit element).

    (b) When contracts' cash flows are more stable and predictable. These contracts benefit from investment returns because the insurer is better able to match duration of assets with duration of liabilities. In contrast, the investment strategy for issuers of contracts with less predictable cash outflows is, generally, one of liquidity management (investment in shorter term, highly liquid assets) because of the uncertainty in the amount (severity) and timing of claims.

45. In contrast, some contracts are not priced to reflect an insurer's opportunity to invest the premiums over a long period of time to mature to fund the contract

obligation or make up for potential underwriting losses. Under these contracts, the pricing of the premium is sufficient to cover the potential losses and profitability issues are addressed through re-pricing and re-underwriting. Thus, the pricing of these contracts does not contemplate risks related to future renewal periods in the same manner as the contracts described in paragraph 44. Based on the contract boundary principles tentatively decided by the boards in March, contract renewals should be treated as a new contract when specified criteria are met, including when the insurer has the right or the practical ability to reassess the risk of the portfolio, and can set a price that fully reflects that risk. Respondents proposed using contract boundary principles as potential eligibility requirements for the premium allocation approach.

Interaction with presentation

46. In assessing whether the building block approach provides more relevant information than the premium allocation approach, relative to the cost of providing that information, the boards need to compare the relevance of possibly more timely recognition of changes in estimates of cash flows and risk adjustments to the relevance of the presentation of premium revenue and claims and claims adjustment and benefits expenses in the statement of comprehensive income.

Staff Recommendation and question for boards

Question 1 for the boards

Do the boards agree that insurers should apply the building block approach, rather than the premium allocation approach when either of the following apply:

(a) The building block approach provides more relevant information than the premium allocation approach, relative to the cost of providing that information. This might be the case if the portfolio of contracts have either of the following features:

  (i) The expected cash flows before the claim is incurred are expected to vary significantly over the coverage period (for example, the contract contains options and guarantees that significantly affect the variability of cash flows based on changes in market factors) and such variance is not expected to result in

recognition of an onerous contract adjustment; and

(ii) (for the IASB) the risk in the contract associated with the liability for remaining coverage has the potential to vary significantly.

(b) It is difficult to allocate the premium in a reliable and rational manner. This would be the case in any of the following circumstances:

(i) It is difficult to determine the amount of premium to allocate for example because the contract contains significant deposit elements that are not unbundled.

(ii) There is significant uncertainty about the length of the coverage period, for example because the contract includes options for renewal.

(iii) It is difficult to identify and separate the insurers' obligations to the policyholder arising from the contract, for example contracts where the expected payments to policyholders are affected by complex interdependent options.

A word on the coverage period

47. In many cases, the features in Question 1 are correlated with the length of the coverage period. The longer the contract is:

    (a) The greater the potential for significant changes in expectations about claims arising in the remaining coverage period.

    (b) The more significant the effect of the options and guarantees.

    (c) The greater the potential uncertainty of the length of the coverage period, and therefore the greater the difficulties in allocating the premium.

48. For this reason, the building block approach is associated with longer duration contracts – such contracts generally have the features that make it difficult to apply existing IFRSs and non-insurance US GAAP. This is also the reason that the IASB's ED proposed to specify eligibility for the premium allocation approach on the basis of time: it was implicit that the premium allocation approach should be applied when the differences between the building block approach and the premium allocation approach were not significant.

49. If the boards agree with the analysis above and base the criteria for eligibility to the short duration approach in line with that analysis, one approach would be to specify eligibility criteria only in principled terms. This would address concerns that the criteria proposed in the exposure draft were arbitrary.

50. However, stating the eligibility criteria purely in principled terms would require insurers to apply judgment in how to interpret them, and introduce subjectivity. This could be avoided by identifying specific features of contracts which are eligible for the premium allocation approach.

51. Some staff think the criteria in Question 1 support the exposure draft proposal to limit the premium allocation approach to contracts with a short coverage period as a short cut or practical expedient for determining when the principles-based criteria apply. However, those staff believe that the ED proposal could be modified to specify a less restrictive definition of 'short-duration' so that the premium allocation approach could be used for:

    (a) contracts that are somewhat longer than one year (possibly up to two years) in duration; and

    (b) portfolios of contracts in which most of the contracts are short-duration, but a few are longer-duration.

    Accordingly, for portfolios of contracts in which most of the contracts' coverage periods are approximately one year or less, the liability for remaining coverage could be measured using the premium allocation approach.

52. However, other staff think that only the principles described in Question 1 should be used to determine when the building block approach should be applied. These staff think that, although the relationships described in paragraph 47 will exist for many portfolios of contracts, the nature of the insured risk and the contract terms (other than the length of coverage) will often be a better indicator than the length of coverage as to whether (a) the building block approach provides more relevant information for these portfolios than the premium allocation approach, relative to the cost of providing that information and (b) it is difficult for the premium on these portfolios to be reliably determined and allocated in a rational manner. For example, a portfolio of two year personal automobile physical damage coverage contracts will, generally,

have less potential for significant changes in expectations about claims arising in the remaining coverage period than a portfolio of one year directors and officers policies. Additionally, the use of a one year coverage period criterion is arbitrary and would result in products identical in terms of risks and exposures, but with different durations, being accounted for and presented differently. Examples of such contracts are included in Appendix C.

53. Perhaps more importantly, these staff think that a one-year expedient, rather than applying only the principles in Question 1 would lead to insurers applying the building block approach to those contracts for which users place more value on information about the premium revenue, and claims and claims adjustment expenses for the reporting period. This would lead to an undesired trade-off from users' perspectives – one which subordinates presentation to the more timely recognition of changes in estimates when those changes would not result in a contract loss and would be remote in some cases.

Question 2 for the boards:
Do the boards think that, for portfolios of contracts in which most of the contracts' coverage periods are approximately one year or less, the insurer should always be permitted to measure the liability for remaining coverage using the premium allocation approach?

Appendix A – Respondent feedback on the premium allocation approach (as included in the staff premium allocation approach paper from July)

A1. 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.

A2. 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.

A3. 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

A4. 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

A5. 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.

A6. 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.

A7. 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.

A8. 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:

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

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

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

d. the claims payment period is short.

e. there is relatively little uncertainty in the amount and timing of claims.

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

Permit or require

A9. 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.

A10. A small number think that the modified approach should be mandated. This includes many, but not all, users.

Appendix B – Exposure Draft Basis for Conclusions Paragraphs 20 – 32

Revenue recognition

BC20 If an insurer applied the proposals in the exposure draft *Revenue from Contracts with Customers* ('the proposed revenue recognition model'), to the service elements of the premium, the insurer would:

(a) identify the separate performance obligations in the contract, and allocate the revenue element across those performance obligations to determine the transaction price for each performance obligation.

(b) measure those performance obligations that remain unsatisfied at the amount of transaction price that is allocated to those performance obligations.

(c) recognise an additional liability if a performance obligation is onerous.

(d) recognise revenue as the insurer satisfies a performance obligation by providing insurance coverage. Typically, revenue would be recognised continuously over the coverage period.

(e) recognise a claims liability when a claim is incurred.

BC21 It would not be difficult to apply the revenue recognition model to some types of insurance contract, eg many short-duration contracts, and that model would provide useful information for users. Indeed, the result of applying the revenue recognition model to those contracts would be largely similar to the approach proposed in the draft IFRS on insurance contracts. Paragraphs BC145–BC148 explain this in more detail.

BC22 However, for other types of insurance contract, it would be much more difficult to apply the revenue recognition model and the results would be of limited use to users. Examples of some of the problem areas are:

(a) stop-loss contracts and some contracts with significant deductibles.

(b) contracts for which the expected cost of an insured event is likely to fluctuate both up and down over time (eg for some types of guarantee).

(c) contracts that implicitly provide protection against a decline in insurability.

(d) annuities.

(e) investment management services in participating insurance contracts.

BC23 The following example illustrates the problem with applying the proposed revenue recognition model to stop-loss contracts and to contracts with deductibles. Suppose a stop-loss contract covers 90 per cent of aggregate losses during 2010 that exceed CU10 million,[9] up to a maximum payment of CU9 million (ie 90 per cent of aggregate losses in the layer between CU10 million and CU20 million). The premium is, say, CU1.2 million. Consider

[9] In this Basis for Conclusions monetary amounts are denominated in 'currency units (CU)'.

now the position at 30 June 2010. Suppose that aggregate losses for the first six months are CU5 million, and aggregate losses for the rest of the year might be less than CU5 million (probability 60 per cent), between CU5 million and CU15 million (total probability 35 per cent, with all amounts within that range equally likely) or CU15 million or more (probability 5 per cent). To apply the revenue recognition model to this contract, it would be necessary to answer the following questions:

(a) To what extent has the insurer satisfied its performance obligation at 30 June 2010? How much revenue should the insurer recognise at that date as a result?

(b) How much, if any, should the insurer recognise as a claims liability at 30 June 2010? At that date it does not yet know whether it will be required to pay any claims at all for the year, but it could have to pay as much as CU9 million for the year as a whole, and the expected value of its payments for the whole year is CU2,025,000.[10]

BC24 Applying the model proposed in the draft IFRS, the insurer does not need to identify an amount of revenue attributable to the coverage for the six months to 30 June 2010, or to identify an amount of 'incurred' losses at that date. It simply measures the contract as the sum of the expected present value of the remaining cash flows (the present value of CU2,025,000) plus a risk adjustment plus the remaining amount of the residual margin identified at inception.

BC25 The revenue recognition model is also not particularly well suited to contracts for which the risk is likely to fluctuate both up and down over time (eg for some types of guarantee). Suppose an equity-linked life insurance contract provides a death benefit equal to the higher of (a) the account value and (b) 100 per cent of the amount invested. Thus, the insurer bears the risk that the policyholder may die at a time when the account value is less than the amount invested. For bearing this risk, the insurer charges an explicit or implicit additional premium of CU1,000. Halfway through the life of the contract, what part of the insurer's performance obligation has it satisfied if the account value stands at (a) 130 per cent of the amount invested? (b) 100 per cent of the amount invested? (c) 70 per cent of the amount invested? What if the account value goes down to 70 per cent of the amount invested and then goes back up to 100 per cent? The revenue recognition model does not provide ready answers to these questions.

BC26 Many life insurance contracts pose another difficulty for the revenue recognition model. Consider a 20-year life insurance contract with monthly fixed level premiums, with the insurer having no ability to reprice the contract during its term. The premium paid for each month provides the policyholder with two benefits:

(a) coverage against death during that month.

[10] There is a 35% probability that the insurer will pay CU4,500,000 and a 5% probability that it will pay 9,000,000. Thus, the expected value of losses for the whole year = (35% × 4,500,000) + (5% × 9,000,000) = CU2,025,000.

(b) coverage against the possibility of a decline in insurability, or even against becoming uninsurable, in the event of bad health.

BC27 In principle, the revenue recognition model would require the insurer to estimate at inception the stand-alone selling price for each month of coverage, or find some reasonable approximation that would allocate the total premium in a reasonable way across each month of coverage. Moreover, for the coverage for, say, the 70th month of cover, the revenue recognition model would require the insurer, at least in principle, to estimate the stand-alone selling price at inception for that month's coverage. Estimating that price is likely to be difficult because insurers do not generally sell such forward coverage separately. The pricing of such forward cover would need to consider how the characteristics of a portfolio might change between inception and the 70th month for example, because of adverse selection (ie the fact that the policyholders with different characteristics are likely to exercise lapse or other options in different ways, leading to an increasing concentration of policyholders who present above-average levels of risk).

BC28 A life-contingent annuity can be viewed as a series of pure endowments. A pure endowment is a contract that pays a specified benefit if the policyholder is alive on a specified date. Each of those pure endowments obliges the insurer to stand ready to pay out the specified benefit if the policyholder survives to the specified date. Thus, for annuities, the revenue recognition model would, in principle, require the insurer to allocate the total transaction price across each pure endowment contained in the contract. Assuming the annuity requires monthly payments, the insurer would recognise each month as revenue the portion of the transaction price allocated to the obligation maturing in that month. Furthermore, for policyholders who die during the month, the insurer no longer has any performance obligations to them and so would recognise the remaining transaction price as revenue during that month. And if the policyholders are expected to live longer than previously expected, the insurer would need to reallocate transaction price across performance obligations accordingly. The resulting model is not likely to provide useful information to users and it is likely to be complex to implement.

BC29 For some participating insurance contracts, the insurer provides investment management services and provides a guarantee of minimum investment returns, receiving in exchange a portion of the upside potential on the underlying assets. The revenue recognition model would require the insurer to identify and estimate the amount of consideration receivable from the policyholder (in the form of a portion of the upside potential) and allocate it across satisfied and unsatisfied performance obligations.

BC30 A further problem arises because the revenue recognition model applies different approaches to contract rights and unsatisfied performance obligations, by measuring:

(a) the contract rights on an expected present value basis.

(b) the unsatisfied performance obligations at the amount of consideration allocated to those obligations, supplemented by an onerous contract test based on future cash flows.

BC31 Applying different approaches to contract rights and performance obligations amounts to an implicit assumption that the contract generates two separate streams of cash flows that are independent of each other. However, that is not the case for many insurance contracts. As an example, consider a 20year life insurance contract with monthly premiums. If the contract lapses because the policyholder does not pay the premium for month 60, the insurer will not pay death benefits if the policyholder dies in month 61 or after. Similarly, if the policyholder dies in month 35, the insurer will not receive premiums for month 36 or after. Accounting for the inflows separately from the outflows would not represent their nature faithfully because it would imply that the inflows and outflows do not affect each other. In contrast, the approach proposed in the draft IFRS treats all inflows and outflows in the same manner.

BC32 In summary, applying the revenue recognition model would be relatively easy for some insurance contracts (eg many short-duration contracts) and would provide relevant information for users, but would be complex and produce information of limited relevance for other types of insurance contracts. In contrast, the model proposed in the draft IFRS would provide useful information for all types of insurance contract.

Appendix C – Examples of non-life contracts that may have a duration longer than one year

C1. Surety contracts that insure a construction period which may be 3-5 years

C2. Construction policies for general liability that extend for the duration of the construction

C3. Small commercial coverage policies where there is no cost benefit to perform annual underwriting

C4. 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

C5. 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

C6. Satellite business which covers the period of time from launch through duration of orbiting

C7. 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

C8. 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)