STAFF PAPER

Week commencing 27 February 2012

FASB | IASB Meeting

Project	**Insurance Contracts**
Paper topic	Premium Allocation Approach: Amendments to the January staff recommendations on Eligibility and Mechanics

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Purpose of this paper

1. During January 2012, the IASB and the FASB held education sessions to discuss the following papers:
   (a) 2A/78A – Premium allocation approach: Eligibility criteria;
   (b) 2B/78B – Premium allocation approach: Mechanics.
2. No decisions were made at the meetings in January 2012. These papers are reproduced as agenda papers 3F/79F and 3G/79G respectively.
3. As a result of the education sessions, feedback from constituents, and additional analysis, the staff:
   (a) Revised the eligibility criteria in 2A/78A to be clearer and to avoid unintended consequences.
   (b) Revised the practical expedient in 2B/78B regarding when the measurement of the liability for remaining coverage should reflect the time value of money.
4. This paper discusses the proposed changes and the reasons for them.

Staff recommendation

Premium allocation approach – Eligibility

5. In 3H/79H *Premium allocation approach: IASB staff recommendations*, the IASB staff propose that eligibility for the premium allocation approach should be determined by an overall principle. If this recommendation is accepted, the eligibility criteria described in this paper would be included as application guidance supporting that overall principle.

6. In AP3I/79I *Premium allocation approach: FASB staff recommendation*, the FASB staff propose that eligibility for the premium allocation approach should be determined by the eligibility criteria as revised in this paper.

7. The staff recommend eligibility criteria as follows:

   (a) Insurers should apply the building block approach rather than the premium allocation approach if, at the contract inception date, either of the following conditions is met:

      (1) It is likely that, during the period *before* a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract; or,

      (2) Significant judgement is required to allocate the premium to the insurer's obligation to each reporting period. This may be the case if, for example, significant uncertainty exists about:

         (a) the premium that would reflect the exposure and risk the insurer has for each reporting period; or

         (b) the length of the coverage period.

8. The staff also recommend that the following should be included in application guidance as indicators that the eligibility criteria are met:

   (a) The existence of guarantees or options in an insurance contract may indicate that there is likely to be a significant change in expected net cash flows to fulfil the contract, unless the cash flows resulting from those guarantees and options are substantially offset by variations in premiums.

(b) Some circumstances could likely cause expected cash flows to change subsequent to contract inception, but such changes will not always *significantly* change the expectations of net cash flows at contract inception. Other circumstances could cause expected cash flows to change significantly subsequent to contract inception, but are not *likely* at contract inception.

(c) If, at contract inception, an insurer believes that, during the contract's coverage period, it is likely to significantly change premium pricing for future contracts written with similar or identical risks, this could indicate a significant change in the expectations of net cash flows for the existing contract.

(d) The longer the coverage period of a contract, the more likely it is that there will be a significant change in the expected net cash flows to fulfil the contract, as compared to a shorter coverage period.

9. In addition, the FASB staff recommend that the examples included in Appendix E of Agenda Paper 2A/78A be included in the application guidance. The IASB staff recommend that these examples not be included as application guidance.

Premium allocation approach – Mechanics

10. The FASB staff recommend the liability for remaining coverage should not be discounted and interest should not be accreted on the liability (Alternative A).

11. The IASB staff recommend (Alternative B):

(a) Discounting and interest accretion should be required in the measurement of the liability for remaining coverage for contracts that have a significant financing component.[1]

(b) The board should provide a practical expedient that permits insurers not to adjust the measurement of the liability for remaining coverage to reflect the time value of money, aligned with the proposals in the exposure draft *Revenue from Contracts with Customers*. This would state that insurers need not adjust the measurement of the liability for remaining coverage to reflect the time value of money if the insurer expects at contract inception that the period of time between payment by the policyholder of all or substantially all of the premium and the satisfaction of the insurer's obligation to provide insurance coverage will be one year or less.

12. The FASB staff recommend that, if the boards decide to require discounting and accretion of interest, the wording of the practical expedient should instead be as follows:

> As a practical expedient, insurers need not apply discounting or interest accretion to reflect the time value of money in measuring the liability for remaining coverage if the insurer expects at contract inception that the period of time between payment by the policyholder of all or substantially all of the premium and the satisfaction of the insurer's ***corresponding*** obligation to provide insurance coverage will be one year or less.

[1] In assessing whether a financing component is significant to a contract, an entity shall consider various factors, including any of the following:

(a) The expected length of time between the receipt of initial premium and the coverage period

(b) Whether the amount of consideration would differ substantially if the customer paid in cash upfront or over the coverage period

(c) The interest rate in the contract and prevailing interest rates in the relevant market.

Staff analysis

Eligibility for the premium allocation approach

13. In agenda paper 3F/79F *Premium allocation approach: Eligibility criteria* the staff recommended that insurers should apply the building block approach rather than the premium allocation approach if, at the contract inception date, *either* of the following conditions is met:

    (a) It is likely that, during the period *before* a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfill the contract that would not be captured by the onerous contract test ('expected cash flows criterion').

    (b) Significant judgment is required to determine the amount of premium to be recognised in each reporting period, for example if there is significant uncertainty about the length of the coverage period ('allocation of premium criterion').

14. Based on feedback from the education sessions in January 2012 and further analysis, the staff considered the following items:

    (a) Onerous contract test

    (b) Judgement required to determine the allocation of premium

    (c) "And" versus "Or"

    (d) Change in the expectations of net cash flows

    (e) Guarantees and options

Onerous contract test

15. At the January 2012 education sessions, several board members expressed concern that the reference to the onerous contract test in the expected cash flow criterion might result in unintended consequences. Specific concerns were:

    (a) Some life or long-duration contracts could be eligible for the premium allocation approach. Current US GAAP accounting requires a loss recognition test (and IFRS 4 requires a loss adequacy test) to determine when there have been significant changes in expected cash flows such that the insurer anticipates a loss on the contract(s). If the premium allocation approach were applied to life or long-duration contracts, the assumptions would be locked in until there was a loss. However, one of the boards' objectives was to improve current accounting, which included unlocking assumptions in life and long-duration contracts to indicate deteriorating or improving conditions to users of the financial statements on a timely basis rather than waiting until the cash flows actually occur.

(b) In the proposed language, "to be captured by the onerous contract test," an additional liability would need to be recorded. However, an additional liability is only recorded if it is determined that there will be a loss on the contract (e.g., the present value of the expected cash outflows exceeds the liability for remaining coverage). Therefore, adverse changes in expected cash flows that do not trigger the recognition of an onerous contract liability would not be "captured". For example, a potential movement in an expected loss ratio from sixty percent to seventy percent might require a contract to be measured under the building block approach, as this change in expected cash flows would not be captured by the onerous contract test. Therefore, if this language were included, very few, if any, contracts might be eligible for the premium allocation approach.

16. The reason the clause "that would not be captured by the onerous contract test" was added to the criteria was to allow insurers to use the premium allocation approach for some contracts where there may be an indication of changes in expected cash flows before an insured event occurs. For example, the expectations of catastrophic losses can change from before a storm is first forecast until the adverse event occurs (or does not occur) and variations in expected cash flows can occur throughout this time. For other catastrophe

events, e.g. an earthquake, the adverse event happens instantly with little or no change in expectations of catastrophic losses. However, the staff notes that for hurricanes and earthquakes, variation in cash flows would likely result in greater net cash outflows than those expected at the beginning of the contract. Such variations in cash flows would indicate that an onerous contract test would need to be performed and a liability would be recorded if it was determined that the expected adverse event is significant enough to constitute an onerous contract. Another example is a surety contract where deterioration in the economic environment could indicate that a contractor may not complete an insured project. Again, these changes in expectations could trigger the onerous contract test to be performed.

17. Based on constituent feedback, the staff have removed the reference to the onerous contract test from the expected cash flow criterion and added an indicator in the application guidance that would capture some of the concerns expressed in paragraph 16. The staff believe that including the following application guidance would alleviate these concerns:

> "Some circumstances could likely cause expected cash flows to change subsequent to contract inception, but such changes will not always *significantly* change the expectations of net cash flows contract inception. Other circumstances could cause expected cash flows to change significantly subsequent to contract inception, but are not *likely* at contract inception."

18. In addition, the IASB staff believe that the need for the reference to the onerous contract test is considerably reduced if the eligibility for the premium allocation approach is determined by a practical expedient.

Judgement required to determine the allocation of premium

19. With respect to the allocation of premium criterion, the staff received constituent feedback that the phrase "judgement is required to determine the amount of premium to be recognised" was not clear. The staff's intent was to capture contracts in which it was difficult to determine the amount of premiums

earned to be recognized in profit or loss each reporting period under the premium allocation approach. As noted by the staff in past Agenda Papers, the process of determining the amount of premium to be recognised each period could be difficult and arbitrary for some types of contracts leading to a lack of consistency between contracts. For example, the method used to derive the premiums earned for a single premium whole life contract might yield misleading results when applied to a twenty-year term life contract or an annuity contract.

20. To clarify the staff's intent, the revised criterion uses the wording in the proposed Accounting Standards Update, *Revenue from Contracts with Customers*, which indicates when revenue should be recognized. Paragraph 49 of the proposed ASU states:

> When (or as) a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price allocated to that performance obligation.

21. The staff have modified this wording to make it applicable to insurance contracts as follows:

> Significant judgment is required to allocate the premium to the insurer's obligation to each reporting period.

22. To capture some of the feedback the staff believe this criterion should include examples as follows:

> This would be the case if, for example, significant uncertainty exists in determining:
>
> (a) the premium that would reflect the exposure and risk the insurer has for each reporting period; or
>
> (b) the length of the coverage period.

23. These examples are intended to be consistent with the reasoning underlying the boards' tentative decision made in April 2011 that, under the premium allocation approach, the insurer should reduce the measurement of the liability

for remaining coverage over the coverage period on the basis of time or on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. The FASB's Discussion Paper, *Preliminary Views on Insurance Contracts*, described the reasoning for this as follows: "As the insurer fulfils the obligation to provide insurance coverage continuously over the coverage period, the insurer would be released from risk and the related part of the premium would be considered earned and therefore, would be recognized as revenue in the current period." This is consistent with the customer consideration approach in the proposed Accounting Standards Update/Exposure Draft, *Revenue from Contracts with Customers.* The examples apply this reasoning as follows:

(a) Example (a) in paragraph 22 above includes the concept of when the insurer is released from risk.

(b) Allocating premium to the insurance obligation is easier if a contract has a fixed coverage period. Example (b) in paragraph 22 above addresses uncertainty about the coverage period. Uncertainty about the coverage period is typical in life contracts (where the lifespan of the policy holder is uncertain) or contracts that include policyholder options to extend or terminate the coverage period.

And versus Or

24. Some board members asked the staff to explore whether an insurer should be required to apply the building block approach only when *both* of the criteria are met instead of when *either* of the criteria is met.

25. The staff believe that the boards have previously indicated that both criteria are important for determining whether the building block approach should be used. In addition, although the staff has not identified unintended consequences of requiring contracts to meet both criteria, such consequences could exist. Consequently, the staff did not revise the criteria to stipulate that a contract should meet both criteria to be required to use the building block approach.

Change in the expectations of net cash flows

26. Some board members raised the fact that a trend of adverse events could cause the expectations of the frequency of additional adverse events to change. For example, if there are numerous home burglaries in a particular area, the likelihood that a policyholder's home in the same area will be burglarized will increase. The staff observed that the anticipation of these potential circumstances would not necessarily impact an insurer's expectation of changes in cash flows at a contract's inception. If the circumstances that could cause the expected cash flows to change subsequent to a contract's inception are not considered likely, then these circumstances would not affect an insurer's expected cash flows at the contract's inception, and the expected cash flow criterion would not be met.

27. An insurer expects a particular amount of losses when it writes a portfolio of insurance contracts and includes this expectation in its premium pricing. These expectations are based on historical experience and are updated for current conditions. If, at contract inception, an insurer believes that, during the contract's coverage period, it will significantly change premium pricing for future contracts written with similar or identical risks, this could indicate that it believes there will also be a significant change in the expectations of net cash flows for the existing contract. Changes in premium pricing are intended to maintain a particular level of profitability for the insurer. Thus, an insurer's expectation that pricing will change for future contracts with similar or identical risks may indicate the insurer's belief that the loss ratio, and therefore the expected net cash flows, are likely to change for the existing contracts in-force.

28. The staff believe that a significant change in the expectations of net cash flows required to fulfil the contract would be more likely to occur during a longer coverage period.

29. The staff have captured these points in the indicators proposed to be included in the application guidance:

(a) Some circumstances could likely cause expected cash flows to change subsequent to contract inception, but such changes will not always *significantly* change the expectations of net cash flows contract inception. Other circumstances could cause expected cash flows to change significantly subsequent to contract inception, but are not *likely* at contract inception.

(b) If, at contract inception, an insurer expects that, during the contract's coverage period, it will significantly change premium pricing for future contracts written with similar or identical risks, this could indicate a significant change in the expectations of net cash flows for the existing contract.

(c) The longer the coverage period of a contract, the more likely it is that there will be a significant change in the expected net cash flows to fulfil the contract, as compared to a shorter coverage period.

30. The indicators in (b) and (c) above also capture the concepts from the current US GAAP language,[2] which many respondents suggested as the eligibility criteria for when the premium allocation approach should be used.

Guarantees and options

31. The staff note that the existence of a guarantee within a contract could significantly affect the expected net cash flows in a contract because they could increase the benefit to the policyholder unless there is a corresponding increase in premiums.

32. The existence of options within a contract can affect both the length of the coverage period and expectations about cash flows.

33. Hence, the presence of guarantees and options can create additional insurance risk and increase the likelihood that, during the period before a claim is

[2] Short duration contracts are 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 charged or coverage provided.

incurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract.

34. Guarantees and options also necessitate the use of significant judgment regarding the amount of premium to be recognised. The existence of these guarantees and options thus indicates that there is likely to be a significant change in expected net cash flows to fulfil a contract, or that significant judgement is required to allocate the premium to reporting periods.

35. Therefore, the staff have proposed to include in application guidance the following:

> "The existence of guarantees and options in an insurance contract may indicate that there is likely to be a significant change in expected net cash flows to fulfil the contract, unless the cash flows resulting from those guarantees and options are substantially offset by variations in premiums."

Staff recommendation

Question 1 - Eligibility criteria
The staff recommend the following eligibility criteria, either in the standard or as application guidance as discussed in AP3H/79H *Premium allocation approach: IASB staff recommendations* and AP3I/79I *Premium allocation approach: FASB staff recommendations*: Insurers should apply the building block approach rather than the premium allocation approach if, at the contract inception date, either of the following conditions are met: (a) It is likely that, during the period before a claim is incurred, there will be a significant change in the expectations of net cash flows required to fulfil the contract; or,

(b) Significant judgement is required to allocate the premium to the insurer's obligation in each reporting period. This may be the case if, for example, significant uncertainty exists about:

i. the premium that would reflect the exposure and risk the insurer has for each reporting period; or

ii. the length of the coverage period.

Question 2 – Application guidance

The staff also recommend that the following indicators are included in the application guidance:[3]

(a) The existence of guarantees and options in an insurance contract may indicate that there is likely to be a significant change in expected net cash flows to fulfil the contract, unless the cash flows resulting from those guarantees and options are substantially offset by variations in premiums.

(b) Some circumstances could likely cause expected cash flows to change subsequent to contract inception, but such changes will not always significantly change the expectations of net cash flows contract inception. Other circumstances could cause expected cash flows to change significantly subsequent to contract inception, but are not likely at contract inception.

(c) If, at contract inception, an insurer expects that, during the contract's coverage period, it will significantly change premium pricing for future contracts written with similar or identical risks, this could indicate a significant change in the expectations of net cash flows for the existing contract.

(d) The longer the coverage period of a contract, the more likely it is that there will be a significant change in the expected net cash flows to fulfil the contract, as compared to a shorter coverage period.

[3] The staff note that these indicators could be subject to wording changes.

Mechanics of the premium allocation approach

36. Agenda paper 3G/79G *Premium allocation approach: Mechanics* sets out the staff's recommendations regarding the mechanics of the premium allocation approach. It is unchanged from Agenda Paper 2B/78B that was discussed by the Boards at the education sessions in January.

37. That paper discusses whether to adjust the liability for remaining coverage for the time value of money and sets out two alternatives:

    (a) Alternative A – the measurement of the liability for remaining coverage should not be discounted and interest should not be accreted on the liability.

    (b) Alternative B – discounting and interest accretion should be required in the measurement of the liability for remaining coverage for contracts that have a significant financing component and, as a practical expedient insurers need not apply discounting or interest accretion if the coverage period of the contracts is less than one year.

38. The FASB staff recommends alternative A; the IASB staff recommends alternative B.

39. After posting Agenda Paper 2B/78B in January, the staff became aware that the practical expedient, as recommended in alternative B, would result in different results from the practical expedient in the Revenue Recognition exposure draft. Paragraph 60 of the exposure draft states:

    > As a practical expedient, an entity need not adjust the promised amount of consideration to reflect the time value of money if the entity expects at contract inception that the period between payment by the customer of all or substantially all of the promised consideration and the transfer of the promised goods or services to the customer will be one year or less.

40. The staff intended that the recommendation in alternative B should be consistent with the proposals in the Revenue Recognition exposure draft.

41. If the wording of alternative B is aligned with the wording used in the Revenue Recognition exposure draft, the practical expedient in alternative B will read as follows:

> As a practical expedient, insurers need not adjust the liability for remaining coverage to reflect the time value of money if the insurer expects at contract inception that the period between payment by the policyholder of all or substantially all of the premium and the provision of insurance coverage will be one year or less.

42. The staff note that there is some uncertainty around the interpretation of the wording used in the Revenue Recognition exposure draft. Specifically, there is confusion regarding whether the expedient refers to continuous insurance coverage over the contract term (i.e. coverage corresponding to the payment that relates to that coverage), or to the length of the contract term itself.

43. To illustrate this point, consider the following examples:

    (a) An insurance contract with a coverage period of two years where payments are paid monthly in advance.

    (b) An insurance contract with a coverage period of three years with premiums paid annually in advance.

    (c) An insurance contract with a coverage period of three years with all premiums paid at the beginning of the first year of coverage.

44. Some staff believe that the practical expedient as worded in the Revenue Recognition exposure draft would not apply to any of these contracts because the insurer's obligation is to provide insurance coverage over more than one year (although it is likely that if the payments are made each month the financing component will not be significant).

45. Other staff believe that the practical expedient would apply to contracts (a) and (b) because the period between payment by the policyholder of the premium and the insurer's corresponding obligation to provide insurance coverage is less than one year; in contract (a) it is one month, and in contract (b) it is one year.

These staff believe that the practical expedient would not apply to contract (c) because the period between payment by the policyholder of the premium and the satisfaction of the insurer's corresponding obligation is three years.

46. The Revenue Recognition team have indicated that they intend to revisit the wording of this section of the exposure draft during redeliberations.

47. Despite this uncertainty, the IASB staff believe that the wording of alternative B should be consistent with the wording of the Revenue Recognition ED. Any changes to the Revenue Recognition ED made as a result of redeliberations should be incorporated in the proposals in the Insurance contracts project at a later date. This approach ensures consistency with the revenue recognition proposals.

48. However, the FASB staff believe that the wording of alternative B should be revised to refer to the period between when a payment of premium is made and the satisfaction of the corresponding insurance obligation. This period of time is important because it represents the difference between when the insurer has collected the premium, but before it has performed under the contract. Therefore, the insurer has access to the premiums in advance of providing insurance coverage to the policyholder, potentially indicating a time value of money.

49. The FASB staff believe that including wording that has been identified as confusing and where clarification is necessary is inefficient. Consequently, they recommend that the practical expedient in alternative B should be reworded to state:

> As a practical expedient, insurers need not adjust the liability for remaining coverage to reflect the time value of money if the insurer expects at contract inception that the period between payment by the policyholder of all or substantially all of the premium and the satisfaction of the insurer's corresponding obligation to provide insurance coverage will be one year or less.

50. If the wording in paragraph 41 is adopted, contracts (a) and (b) in paragraph 43 would qualify for the practical expedient, however, contract (c) would not.

Staff recommendation

51. Agenda paper 2B/78B – Premium Allocation Approach: Mechanics discusses the advantages and disadvantages of alternatives A and B.

Question 3 – Discounting and interest accretion

Do the boards agree with:

Alternative A

The measurement of the liability for remaining coverage should not be discounted and interest should not be accreted on the liability?

Or

Alternative B

Discounting and interest accretion should be required in the measurement of the liability for remaining coverage for contracts that have a significant financing component

In assessing whether a financing component is significant to a contract, an entity shall consider various factors, including any of the following:

a) The expected length of time between the receipt of initial premium and the coverage period
b) Whether the amount of consideration would differ substantially if the customer paid in cash upfront or over the coverage period
c) The interest rate in the contract and prevailing interest rates in the relevant market.

Question 4 - Practical expedient
If the boards decide to require discounting and accretion in the measurement of the liability for remaining coverage (ie Alternative B in Question 3), the staff recommend that, as a practical expedient, insurers need not adjust the liability for remaining coverage to reflect the time value of money if specified conditions are met. Do the boards agree? Which of the following practical expedients do the boards support? Alternative 1 A practical expedient that permits insurers not to adjust the measurement of the liability for remaining coverage to reflect the time value of money aligned with the proposals in the exposure draft *Revenue from Contracts with Customers*. Or Alternative 2 As a practical expedient, insurers need not adjust the liability for remaining coverage to reflect the time value of money if the insurer expects at contract inception that the period between payment by the policyholder of all or substantially all of the premium and the insurer's ***corresponding*** obligation to provide insurance coverage will be one year or less.

Premium allocation approach: mechanics

52. Agenda paper 2B/78B from the January meeting made some additional recommendations regarding the mechanics of the premium allocation approach. These were discussed at the education sessions in January.

53. The staff intend to ask the boards to make tentative decision on these recommendations at this meeting. We have reproduced the staff recommendations on these topics below. The full analysis of these issues can be found in agenda paper 2B/78B.

Question 5 – Measurement of acquisition costs

Alternative 1:

Do the boards agree that:

a) The measurement of acquisition costs should include directly attributable costs (for the FASB, limited to successful acquisition efforts only); consistent with the decisions made under the building block approach; and

b) Insurers should be permitted to expense directly attributable costs that are not incremental

or

Alternative 2:

Do the boards agree that, consistent with the revenue recognition exposure draft:

a) The measurement of acquisition costs should include only incremental costs, and

b) Insurers should be permitted to expense all acquisition costs if the contract coverage period is one year or less (consistent with the revenue recognition exposure draft)?

Question 6 – Presentation

Do the boards agree that:

a) Acquisition costs should be recognised as an asset (and thus the liability for remaining coverage would be gross of acquisition costs)?

b) Acquisition costs should be amortized consistent with the boards' tentative decisions on reducing the liability for remaining coverage (over the coverage period on the basis of time, but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time)?