STAFF PAPER

27 February 2012

FASB | IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Premium Allocation Approach: Eligibility Criteria		

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This paper reproduces, without change, agenda paper 2A/78A from the January meeting. Modifications to the recommendations in this paper are discussed in agenda paper 3E/79E for this meeting. The IASB and FASB recommendations are discussed in agenda papers 3H/79H and 3I/79I respectively.

What is this paper about?

1. The purpose of this paper is to propose eligibility criteria for the premium allocation approach based on the criteria discussed by the boards at the 20 October 2011 meeting, revised to reflect comments received from board members and some stakeholders.

2. This paper does not address:

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a. the mechanics of the premium allocation approach (see Agenda Paper 7B/78B).

b. whether insurers should be permitted, rather than required, to apply the premium allocation approach to contracts that meet the eligibility criteria. This will be the subject of a future paper.

c. whether to introduce a practical expedient to permit (or require) the use of the premium allocation approach for contracts with a coverage period of one year or less. This will also be the subject of a future paper.

Summary of staff recommendation

3. The staff recommends 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 fulfil the contract that would not be captured by the onerous contract test ('expected cash flows criterion').

   (b) Significant judgement 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').

4. In appendix E we show how these criteria would be applied to the contracts used in the testing exercise.

Background

5. The IASB ED proposed a set of eligibility criteria for the premium allocation approach, namely:

The premium allocation approach applies to insurance contracts that meet both of the following conditions:

(a) *The coverage period of the insurance contracts is approximately one year or less.*

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

6. The FASB DP indicated that the board had not determined the extent to or the conditions under which a premium allocation approach would apply.

7. Appendix A provides a summary of respondent feedback on the IASB ED. The boards were sympathetic to addressing some of the concerns raised by respondents. Accordingly, the boards discussed eligibility criteria for the premium allocation approach on three previous occasions, 27 April 2011; 21 July 2011; and 20 October 2011.

8. The first two meetings focused on 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 as well as distinguishing characteristics of different types of insurance contracts. The board members could not reach a consensus on this issue during the first two meetings and dismissed the proposed criteria.

9. The staff then developed principles-based eligibility criteria that were presented at the 20 October 2011 meeting. These criteria were developed by considering what features in a contract mean that a premium allocation approach does not provide sufficiently useful information to users of financial statements, either because current updated information would be notably more useful for the contract (i.e., to a degree where the information value outweighs the incremental costs from application of the more complex building block approach) or because allocation of premiums to each reporting period is not sufficiently relevant or reliable due to extent of subjectivity required in allocation. Said differently, the staff considered

the differences between the premium allocation approach and the building block approach and evaluated the characteristics of types of contracts that should fall within the scope of the two approaches. The staff proposed criteria that would result in an insurer applying the building block approach when it would provide more useful information. These differences, as discussed at the 20 October 2011 meeting, are included in Appendix F.

10. The boards indicated general overall agreement with the principles underlying the eligibility criteria proposed at the October meeting, but requested the staff revise the language used to describe these principles. The boards also requested that the staff test the application of the criteria it developed against different types of insurance contracts. The objective of this exercise was to determine whether the concepts and language in the proposed criteria are clear and operational and whether the results were reasonable. Appendix C includes the eligibility criteria proposed for the exercise, and Appendix E includes the types of insurance contracts to which the criteria were applied.

11. After testing draft criteria with board members, the staff revised the wording of the eligibility criteria as set out in Appendix D to reflect the board members' feedback. The staff tested these revised criteria amongst stakeholders, including preparers; auditors; and actuaries using the same example contracts as were presented to the boards (ie those in Appendix E).

12. As described, the staff have proposed eligibility criteria for the premium allocation approach several times. Previous papers considered and the boards subsequently dismissed some suggestions made by respondents, including that the eligibility criteria should aim to distinguish between "life" and "non-life" types of contracts or should be based on an insurer's business model. The agenda papers presenting each set of proposed eligibility criteria contain substantial discussion of the advantages and disadvantages of each set of criteria, and why each set of criteria was recommended. For the sake of brevity, we have not repeated those discussions in this paper. However, Appendix B includes a summary of each set

of eligibility criteria that the staff previously proposed. We do not intend to reconsider criteria previously considered.

13. The staff will first discuss general feedback received from board members and stakeholders (in paragraphs 14-18), and then discuss each of the proposed eligibility criteria in detail (in paragraphs 19-36).

Staff analysis

General feedback

14. The staff notes that board members and stakeholders tested different criteria from each other and from those that the staff recommend in this paper. The comments below should be read with this in mind.

15. In applying the eligibility criteria, board members and stakeholders generally reached the same conclusions for most of the types of insurance contract. However, the board members and stakeholders did not agree on how to apply the criterion for a number of contracts, namely the contract surety bond (contract 7), catastrophe insurance (contract 8), long-term disability insurance (contract 10) and directors' and officers' insurance (contract 11). To a limited extent, they also did not agree with the outcome of applying those criteria to one-year term life insurance (contract 2) and health insurance (contract 12). The staff addressed the potential reasons for differences in the below paragraphs. We note that although board members and stakeholders often reached similar conclusions, they were asked to test slightly different eligibility criteria.

16. Some common themes in the interpretation of the criteria emerged from the testing exercise:

    (a) *The subjectivity and extent of judgement needed.* One board member indicated that the exercise was too difficult to perform because the criteria provided were subjective and required too much judgement. Others indicated that the determination of the appropriate measurement

model was not always straightforward, and that relatively small differences in assumptions or specific circumstances would result in a different conclusion being reached. However, the staff believe that unless the criteria are rules based they will be subjective and require the use of judgement.

(b) *Assessment of appropriateness of result.* Some stakeholders did not agree with the measurement model that resulted from application of the eligibility criteria to some types of contract. This was the case for term-life insurance contracts with a coverage period of one-year (contract 2). The staff assert this would typically qualify for the premium allocation approach through the application of the drafted eligibility criteria. This view was echoed by almost all the board members and stakeholders. However, a few life insurers believe the building block approach should apply in this circumstance, as term-life is a life contract and they believe that all life contracts should be accounted for on a consistent basis. Similarly, a limited number of respondents believe the appropriate measurement model for the health insurance contract (contract 12) is the building block approach.

(c) *Interaction with contract boundary requirements.* Some noted confusion for the long-term disability insurance (contract 10) and health contracts (contract 12) because of uncertainty about how to apply the contract boundary requirements that the board revised in March 2011. One respondent questioned whether an insurer should determine the measurement model before determining the contract boundary, or vice versa. However, the staff noted that the interaction between the criteria and the boards' tentative decisions on contract boundary was clear to most stakeholders. When applying the eligibility criteria, the staff believe insurers should apply the boards' tentative decisions on contract boundary, and then take into account the features of the contract within the contract boundary. In the staff's view, an insurer should first

determine the boundary of the contract, and then determine the appropriate measurement model, ie insurers should start off by determining what they need to measure before selecting the appropriate measurement model. Similarly, the insurer should consider whether significant judgement is required in determining the amount of premium to be recognised in each reporting period within the boundary of the contract. To make the interaction with contract boundary clear, the staff propose to explain this interrelationship in the application guidance.

(d) *Influence of prior assumptions or current accounting treatment.* The staff noted that different macro-economic conditions could inform the responses of insurers regarding the determination of the measurement model. For instance, the measurement model selected by respondents in France and Japan for surety bond contracts (contract 7) differed and there were differences in the model determined for directors' and officers' insurance (contract 10). The staff observe that the different macroeconomic environments in these jurisdictions[1] might reflect differences in the risk profiles and economics of contracts and that these differing characteristics might, in some circumstances, be better captured in different measurement models. Said differently, different measurement models because of the different macro-economic environments that the contract operates in.

(e) *Unit of account.* Some questioned the unit of account for applying the criteria. Some noted that the criteria could potentially result in using the building block approach for all contracts if the criteria were applied to an *individual* contract because individual contracts almost always have the potential for significant changes in future cash flows, indicating that expected cash flows could change before a claim is incurred in nearly

[1] Examples include the availability of skilled laborers or the regulatory environment, both of which can impact the likelihood of completing the construction of a building within the estimated time frame, which in turn can impact updated cash flow assumptions.

every type of insurance contract. Similarly, if the criteria were applied to portfolios, nearly every insurance contract would fall within the scope of the premium allocation approach, as many long duration life contracts, at the portfolio level, do not experience significant changes in expected cash flows before a claim is incurred. However, the staff did not intend either of these extreme outcomes. Instead, the staff intended that the eligibility criteria be applied to the characteristics of a representative contract or average contract. The staff propose that the determination of whether to apply the building block approach rather than the premium allocation approach should be based on the characteristics of a contract, understanding that once such an assessment is made, contracts with similar characteristics may be similarly grouped. Said differently, an insurer would not have to reassess each individual personal automobile policy it writes to determine which approach to apply. The staff believe this to be consistent with the proposal from some stakeholders that the proposed criteria should be applied to "types" of insurance, and not individual contracts. The staff propose to include application guidance on the unit of account to be used in selecting the measurement model.

(f) *Complexity.* Some stakeholders believe that the criteria were over-engineered. They believe a simpler approach, such as distinguishing contracts between short and long duration, would be less complex and easier to apply. For example, some stakeholders stated that the criteria should use the language in current U.S. GAAP that differentiates between short and long-term contracts, as they stated that this language is well understood and applied and would easily identify which contracts should be eligible for the premium allocation approach. As discussed in paragraph 11, we do not intend to revisit this proposal, which was discussed and rejected in previous meetings.

17. Some sought clarification, as follows:

(a) *Assessment.* It was unclear to some when the eligibility criteria should be applied. The criteria tested among the board and stakeholders referred to making the determination at the "start of the coverage period." Applying the boards' tentative conclusions, the start of the coverage period is when an insurer initially recognises its insurance contract liability. In the staff's view, the application of the eligibility criteria is highly unlikely to be sensitive to the precise date at which the insurer applies those criteria. Accordingly, the staff recommend that the insurer should apply them at contract inception. This allows insurers the ability to use the information gathered for pricing (which results in the initial measurement of the liability for future coverage) and underwriting considerations to determine how the contract is determined. In order to make the assessment at a later date, an insurer would need to re-evaluate those factors at the start of the coverage period which seems inefficient. We will discuss this with the boards at a future meeting if necessary.

(b) *Reassessment.* Some stakeholders were also unclear whether reassessment of the measurement model was permitted or required. The staff believe that the measurement model should be determined only once[2]. Switching between the premium allocation and building block approach will complicate measurement as the mechanics of the premium allocation approach differ from the building block approach. For instance, cash flow estimates are not updated as part of the premium allocation approach.

(c) Whether the premium allocation approach should be permitted or required. Some stakeholders noted their support for permitting rather than requiring the use of the premium allocation approach. As noted in paragraph 2, we will discuss this issue at a future meeting.

[2] The staff will consider in a future paper whether this assessment and others that would otherwise only occur at the inception of a contract should be repeated in circumstances where a contract is significantly modified (i.e., such that it should be effectively viewed as the issuance of a new insurance contract)..

(d) *Desire for application guidance.* Some stakeholders requested that the staff include as application guidance a list of types of contracts (e.g., the ones used in the exercise), the appropriate measurement model, and the rationale for the determination made. The staff will consider application guidance in drafting.

18. Some commented on the approach taken by staff in developing principles-based eligibility criteria as described in paragraph 9. For example:

(a) *The default measurement model.* Some stakeholders noted that the proposed wording implies that the premium allocation approach is the default measurement model. They requested that the criteria be rephrased to make it clear that the building block approach is the default measurement model. The staff will consider this request in drafting.

(b) *Applicability of the premium allocation approach.* Some stakeholders asked why the eligibility criteria focus on the period before the claim is incurred. The staff notes this is the period when the differences between the two measurement models are most pronounced. Irrespective of whether the premium allocation approach or the building block approach is used for the liability for remaining coverage, incurred claims are measured in the same (IASB) or similar (FASB)[3] way as in the building block approach.

Specific comments on eligibility criteria

19. In the following paragraphs, the staff consider comments on the specific eligibility criteria.

[3] The FASB tentatively decided that the liability for incurred claims should be measured *without* a single margin. However, incurred claims measured under the building block approach, are measured *with* a single margin.

Expected cash flows criterion

20. The purpose of the expected cash flows criterion is to identify contracts for which updating cash flow assumptions (ie not locking in assumptions) before a claim is incurred would provide more meaningful information to the users of financial statements. The expected cash flows criterion seeks to identify contracts where there is significant possible variation in future cash flows that could reasonably affect an insurer's expectations in the period before a claim is incurred, indicating the contract is better measured using the building block approach[4].

21. Stakeholders noted that what constitutes "significant" was unclear. Some respondents also indicated that "significant" already has a definition in some GAAPs. For example, in current U.S. GAAP, significance is generally understood to mean a change of 10 percent. Some requested that "significant" be defined in order to reduce the judgment needed to apply criterion. However, the staff do not propose to define "significant". In a principles-based standard, judgement needs to be applied regarding when a particular change is significant and we expect that judgement to be applied elsewhere where we use the word "significant".

22. Some suggested that the staff reconsider the wording "The insurer expects that there could be," from the beginning of criteria one (and two), since they do not believe that they would expect a significant change in the cash flows or risks at the start of the coverage period. They indicated that their expectations would have been incorporated into their pricing and a view could be taken that an insurer may never expect a change in cash flows before the claim event is incurred. The staff changed the wording to "it is likely that there will be". The staff believe that this is clearer. Furthermore, the staff believe the amended wording captures situations where probability estimates are likely to change significantly over the duration of the contract.

[4] For example, in an automobile insurance contract, the insurer's expectations as to whether the insured will have an adverse event are typically the same throughout the contract based on the insured's risk profile. Whereas, in a life insurance contract, the insurer expects assumptions about mortality to change over time.

23. Stakeholders and board members interpreted the cash flows criterion differently for catastrophe insurance (contract 8). We think this is because the cash flows criterion, as drafted, could be interpreted to result in different results for different types of catastrophic events and could result in some catastrophe contracts not qualifying for the premium allocation approach at all.

24. This is because the wording as tested referred to variations in expected cash flows. In the case of a hurricane, the expectations of catastrophic losses can change from when a storm is first forecast until the adverse event occurs[5] (or does not occur) and variations in cash flows can occur in this time. For other catastrophe events, eg an earthquake, the adverse event happens instantly with little or no change in expectations of catastrophic losses. However, the staff notes that for both hurricanes and earthquakes, variation in cash flows would likely only result in greater net cash outflows than those expected at the beginning of the contract. Such variations in cash flows would be measured by the onerous contract test that is included in the premium allocation approach developed by the board. Thus, the staff believe that the onerous contract test would mean the premium allocation approach might provide a sufficient measurement model for *all types* of contracts where the adverse event is significant enough to trigger the onerous contract test (assuming the other criteria are not met). So that insurers can apply the premium allocation approach to catastrophe contracts, the staff added a reference to the existence of the onerous contract test in the expected cash flows criterion.

25. Some questioned whether the boards intended that the cash flows used for the expected cash flows criterion should reflect the time value of money. The staff believes that was not the board's intention. In addition, the staff does not recommend incorporating amending that criterion to refer to variability in the expected present value of the cash flows, rather than their expected value. In the staff's view, including such a reference would add complexity, for little added benefit.

[5] Some believe that the formation of the storm is the adverse event and thus at that time the liability has been incurred (the insurer has an unconditional contractual obligation to the policyholder) with subsequent development of the storm impacting the insurers measurement of its liability.

Risk criterion

26. The eligibility criteria tested with both the board and stakeholders included a risk criterion, ie that the insurer expects that there could be significant change in the risks associated with the expected cash flows during the period *before* a claim is incurred (e.g. updated information affecting the shape of the risk distribution).

27. The staff recommend to delete the risk criterion. It was not clear to some board members how the expected cash flows criterion and the risk criterion differ. The staff addressed this concern in the stakeholder test by adding wording to the eligibility criteria indicating that the expected cash flows criterion was intended to reflect variability of the statistical mean, whereas the risk criterion reflects variability in the *shape* of the risk distribution (Appendix D reflects the revised eligibility criteria presented to stakeholders). The expected cash flows criterion was therefore intended to refer to changes in cash flows that would warrant a change in the measurement of the liability in the financial statements, whereas the risk criterion was intended to refer to the change in the risk adjustment (change in the risk distribution).

28. However, despite the clarification, some stakeholders indicated that there was ambiguity regarding the difference between the expected cash flows criterion and the risk criterion. They indicated that these criteria are interrelated, and it is unclear whether the risk criterion is needed, given that the expected cash flows criterion would in effect cover situations where cash flow distributions are expected to change. The staff agree and believe that in nearly all cases in which the risk criterion would be met, the expected cash flows criterion would also be met. Said differently, it is unlikely there will be a change in the expected risk adjustment without a change in expected cash flows.

29. The staff also noted that stakeholders who completed the exercise never based their assessment on the risk criterion alone. The staff believe this supports the staff's view that this criterion is not necessary.

30. Furthermore, the staff also believe the deletion of the risk criterion will make the eligibility criteria easier and simpler to apply. It will also result in the same

eligibility criteria under both the IASB and FASB models, as explicit reference is not made to the risk adjustment.

Allocation of premium criterion

31. The purpose of the allocation of premium criterion is to identify circumstances where there is significant uncertainty about the total amount of the premium or how to recognise that premium over reporting periods. This might[6] be the case when there is significant uncertainty about the length of the contract, for example, the policyholder may live longer or die sooner than expected, or the contract contains options for the policyholder to terminate or extend the contract.

32. The staff note that this criterion is dependent on the boards' further discussions on unbundling and or disaggregation of deposit elements. The boards' current tentative leaning is that significant deposit components would not be included in the volume information presented in the statement of comprehensive income. The staff will consider the implications of significant deposit components included in volume information if necessary as a result of future board decisions[7].

33. A stakeholder suggested that the wording "the length of the coverage period" should be changed to "the period of time the contract will remain in-force" to reflect consideration of all premium included within the boundary of the contract, ie for the period of time the contract is in effect, or the length of time the insurer is providing coverage. However, the notion of "coverage period" is already used in other areas of the insurance contracts project and that wording better aligns with the wording of the contract boundary decision. The staff therefore recommend not to change the wording only in this criterion, but will consider in drafting whether to

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[6] The existence of uncertainty in the coverage period is considered an indicator that this criterion is met but needs to be considered in the context of its effect on the determination of how much premium would be allocated each period. The staff propose to include application guidance that clarifies that for a typical non-life contract where there is symmetry between the amount of coverage provided each reporting period and the insurer's rights to premium would not meet this criterion even if there is significant risk of cancelation (i.e., because the cancelation risk has no meaningful effect on how much premium would be recognized in each period under these circumstances).

[7] The staff note that specific consideration needs to be given whether or not disaggregation of deposit elements should also apply to contracts for which the premium allocation approach is applied.

revise the wording in all relevant places. The staff intend to clarify in application guidance that the allocation of premium criterion should take into consideration the boards' decisions on contract boundary.

Options and guarantees criterion

34. The eligibility criteria tested with both the board and stakeholders included an options and guarantees criterion, ie that there is uncertainty regarding the expected payments to the policyholder because the contract contains complex interdependent options, including guarantees provided by the insurer and options that can be elected by the policyholder.

35. Some respondents noted difficulties with this criterion as follows:

    (a) Some indicated that the phrase "there is significant uncertainty regarding either the timing or amount of expected payments to the policyholder" does not add much value because uncertainty in cash flows is already captured under the expected cash flows criterion.

    (b) Some respondents indicated that reference to "guarantees" is too generic, and that the words "complex" and "interdependent" do not add much and overcomplicate the wording.

    (c) It was unclear to one respondent whether the reference to options and guarantees refers to both those that have been bifurcated as embedded derivatives (ie unbundled from the host contract) or only those that have not, as discussed in paragraph 29. The staff believe the options and guarantees criterion should be applied *after* the effect of unbundling was considered. Said differently, the building block approach should be applied to contracts that contain options that significantly affect either the timing or amount of expected payments to the policyholder, *after unbundling any embedded derivatives*.

36. The staff notes the building block approach deals better with options and guarantees because those contractual features significantly affect the variability of cash flows. Thus, this criterion specified cases in which the contract would not meet the

expected cash flows criterion because of the presence of options and guarantees. We note that this duplication caused some confusion and we therefore propose to delete the options and guarantee criterion. However, the staff intend to include in the application guidance that the existence of options and guarantees are indicative of a change in expected cash flows.

Staff recommendation

Questions – Proposed eligibility criteria

1. The staff recommend 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 fulfil the liability that would not be captured by the onerous contract test ('Expected cash flows criterion').

(b) Significant judgement 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').

Do the boards agree?

2. Do the boards agree with the deletion of the options and guarantee criterion?

3. Does the IASB agree with the deletion of the risk criterion?

Appendix A: Respondent feedback on the premium allocation approach (as included in July 2011 Agenda Paper 8A/71A)

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 (i.e. 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.

a. 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.

b. 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.

c. 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: Proposed Eligibility Criteria for the Premium Allocation Approach

Date of Joint Board Meeting	Proposed Criteria
Exposure Draft – July 2010	The premium allocation approach applies to insurance contracts that meet both of the following conditions: a) The coverage period of the insurance contracts is approximately one year or less. b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12. Note: Paragraph 12 requires bifurcation of an embedded derivative if both of the following criteria are met, in accordance with IAS 39: a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host insurance contracts. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host insurance contract if, for example, the embedded derivative and the host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately, i.e., without considering the host contract. b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative and be within the scope of IAS 39 (e.g., the derivative is not an insurance contract).

Date of Joint Board Meeting	Proposed Criteria
27 April 2011 (Agenda Paper 1/FASB Memo No. 65)	An insurer is permitted, but not required, to apply the premium allocation approach to contracts must meet all of the following requirements: a) The contract does not include a significant financing element. b) The contract does not contain embedded options or other derivatives that significantly affect the variability of the cash flows, after unbundling any embedded derivatives. Note: A contract does not include a significant financing element if the following criteria are met: a) The time between the receipt of premium and the provision of coverage is insignificant, and b) The amount of premium charged is not substantially different if the policyholder paid at the beginning of the coverage period. Note: As a practical expedient, a contract is not considered to include a significant financing element of the coverage period is one year or less.
21 July 2011 (Agenda Paper 8B/FASB Memo No. 71B) (Staff recommendation 1)	Contracts should be eligible for the premium allocation approach if that approach would produce measurements that are a reasonable approximation of those that would be produced by the building block approach. A contract should be deemed to meet this condition without further investigation if both of the following conditions apply: a) The coverage period is approximately one year or less, and b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash

Date of Joint Board Meeting	Proposed Criteria
	flows, after unbundling any embedded derivatives. Note: The Boards could add guidance to avoid overly restrictive interpretations of "approximately one year." This guidance could clarify that contracts could meet this definition even if they are several months longer than one year and even if there are a few longer-duration contracts within a portfolio of predominantly one-year contracts.
21 July 2011 (Agenda Paper 8C/FASB Memo No. 71C) (Staff recommendation 2)	A portfolio of insurance contracts is eligible for the premium allocation approach if all of the following conditions are met: a) The compensation to the policyholder is based on the amount of the incurred insured loss which is typically variable up to the amount of the policy limit and not a specified amount (other than the limit) in any given contract, b) The period of time between premium receipt and the date of loss is insignificant, and c) The pricing of the premiums does not include risks relating to future renewal periods.
20 October 2011 (Agenda Paper 4B/FASB Memo No. 74B)	Insurers should apply the building block approach, rather than the premium allocation approach, to contracts if 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 in either of the following circumstances: b) 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

Date of Joint Board Meeting	Proposed Criteria
	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; or c) (For the IASB) The risk in the contract associated with the liability for remaining coverage has the potential to vary significantly. d) 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 period, 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. Note: Some recommended 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.

Appendix C: Eligibility criteria used by the board members in testing the eligibility criteria

Proposed Eligibility Criteria

Insurers should apply the building block approach rather than the premium allocation approach to individual contracts if, at the start of the coverage period, any of the following conditions are met:

1. The insurer expects that there could be significant variability in the expected cash flows *before* a claim is incurred (e.g. updated information that would change cash flow assumptions before the claim is incurred).
2. (For the IASB) The insurer expects that there could be significant variability in the risks associated with the expected cash flows *before* a claim is incurred.
3. There is uncertainty regarding the amount of premium to be allocated to each reporting period, for example when there is uncertainty about the length of the coverage period, and/or the contract contains a significant deposit element.
4. There is uncertainty regarding the expected payments to the policyholder because the contract contains complex interdependent options, including guarantees provided by the insurer and options that can be elected by the policyholder.

Appendix D: Eligibility criteria used by stakeholders in testing the eligibility criteria

Proposed Eligibility Criteria

Insurers should apply the building block approach rather than the premium allocation approach to *individual* contracts if, at the start of the coverage period, any of the following conditions are met:

1. The insurer expects that there could be a significant change in the expected cash flows during the period *before* a claim is incurred (e.g. updated information that would change cash flow assumptions and require a recalculation of the expected value of future cash flows (ie statistical mean)).
2. (For the IASB) The insurer expects that there could be significant change in the risks associated with the expected cash flows during the period *before* a claim is incurred (e.g. updated information affecting the shape of the risk distribution).
3. There is significant uncertainty regarding the amount of premium to be allocated to each reporting period, for example when there is uncertainty about the length of the coverage period, and/or the contract contains a significant deposit element that is not unbundled.
4. There is significant uncertainty regarding either the timing or amount of expected payments to the policyholder because the contract contains complex interdependent options, including guarantees provided by the insurer and options (other than those affecting the contract boundary) that can be elected by the policyholder.

Appendix E: Types of contracts used for testing the eligibility criteria

This appendix shows the contracts used for testing the eligibility criteria and the classification the staff thinks would result if the recommended criteria were to be applied.

Type of Contract	***Measurement model that would result from applying the recommended eligibility criteria***
1. **Traditional Whole Life Insurance Contract** – This policy is designed to provide a fixed amount of insurance coverage over the entire life of the insured, provided that premiums are paid as specified in the policy. The premiums remain level over the life of the insured. Payment of the face value of the contract is made upon the death of the insured. This policy also includes an investment component, which accumulates a cash value against which the policyholder can withdraw or borrow. The policy provides the insured with a guaranteed minimum rate of return on the cash value portion.	BBA
2. **Term Life Insurance (1-year)** – Life insurance coverage is provided for one year and does not include the accumulation of cash value. After the term expires, the insurer has the ability to fully underwrite the contract and has no constraints on its ability to re-price.	PAA
3. **Term Life Insurance (5-year)** - Life insurance coverage is provided for five years and does not include the accumulation of cash value. The policy may be renewed for subsequent five-year periods without evidence of insurability. Premiums typically increase each time the policy is renewed, but will not exceed the maximum premiums stated in the policy. Over the five years, the policy has a level term premium for each renewal period. For purposes of this example, based on historical experience, the insurer expects the average policy to renew five times.	BBA

Type of Contract	***Measurement model that would result from applying the recommended eligibility criteria***
4. **Universal Life Insurance** – This is a permanent life insurance policy with terms that are not fixed or guaranteed with respect to premium amounts, expense assessments, or benefits accruing to the contract holder. The policy contains a savings element that is invested to provide a cash value accumulation. The death benefit, savings element, and premiums can be reviewed and altered as the policyholder's circumstances change within certain limits stated in the policy. The cash value grows at a variable rate that is adjusted monthly (sometimes it is pegged to a financial index such as a stock, bond or other interest rate index). The policyholder may use the interest from the accumulated savings to help pay premiums. This policy divides the pure insurance protection, the related expense charge, and the cash value accumulation into separate and distinct components.	BBA
5. **Annuity Life Insurance** – This arrangement guarantees that the contract holder will receive benefits over a fixed or variable period, beginning either immediately or at a future date. Annuities provide either for the payment of benefits until the insured dies, or for continued payments to a beneficiary until a specific number of periods are met. These products may have both fixed and variable features, and other non-traditional features. For purposes of this example, assume a 10-year deferred annuity where the policyholder pays a targeted (with a stated minimum) amount each year. After 10 years the policy begins to pay-out a fixed amount a year which could be adjusted upwards based on the account value accumulation at that date.	BBA
6. **Personal Automobile Insurance** – This policy covers physical damage and personal injury sustained by the insured party. The policyholder	PAA

Type of Contract	*Measurement model that would result from applying the recommended eligibility criteria*
may pay the entire year's premium upfront or on a quarterly or monthly basis. For purposes of this example, assume the policy provides coverage for one year, the physical damage claim is expected to be paid within 6 months of the accident, and the bodily injury claim is expected to be paid out over 18 months. The insurer has the right to fully underwrite the contract and re-price after one year.	
7. **Contract Surety Bond** – This contract provides for monetary compensation to third parties for failure by the construction contractor to construct a building within the estimated time-frame for completion. The insurer agrees to uphold, for the benefit of the third party, the contractor's obligation to construct a building if the contractor fails to perform within the specified time-frame. For purposes of this example, assume the contract term is three years.	PAA* *The staff believe these contracts are particularly impacted by the macro-economic environment. Any significant changes in the macro-economic environment will be picked-up by the onerous contract test. With this in mind, the staff believe these contracts qualify for the premium allocation approach.
8. **Catastrophe Insurance** – This insurance policy covers damage or destruction to the policyholder's business and its contents caused by earth movement or wind damage. For purposes of this example, assume the coverage period is one-year. The insurer has the right to fully underwrite the contract and re-price after one year.	PAA
9. **Workers' Compensation Insurance** – This policy compensates employees for injuries or illnesses sustained in the course of their employment. The payments replace employees' wages and provide additional compensation for the past and future economic losses of the employee. For purposes of this example, assume the policy provides coverage for one year, and, in this case, the pay-out period is estimated to be twenty years. The insurer has the right to fully underwrite the contract and re-price after one year.	PAA

Type of Contract	***Measurement model that would result from applying the recommended eligibility criteria***
10. **Long Term Disability Insurance** – This policy protects the insured against loss of income as a result of the partial or total inability to work as a result of injury, illness, or disease. Typically, long-term disability insurance can be purchased to replace 50-70% of an employee's salary. Long-term disability policies vary in the length of pay-out: some policies will only pay out for 5 or 10 years, some will pay out until age 65. In this case, the pay-out period is until age 65. For purposes of this example, assume a one-year term with guaranteed renewability (the insurer may not cancel the policy under any circumstances). However, the insurer may increase premiums subject to certain conditions, e.g., regulatory approval or adverse morbidity experience. Based on historical experience, the insurer expects the average policy to renew five times.	BBA
11. **Directors and Officers Insurance** – This policy provides liability insurance payable to the directors and officers of a company, or to the organization itself, to cover damages or defence costs in the event they suffer such losses as a result of a lawsuit for alleged wrongful acts while acting in their capacity as directors and officers for the organization. Litigation could take months or years to settle and therefore the pay-out period is unknown. For purposes of this example, assume the policy provides coverage for one-year. The insurer has the right to fully underwrite the contract and re-price after one year.	PAA* *The staff believe these contracts are particularly impacted by the macro-economic environment. Any significant changes in the macro-economic environment will be picked-up by the onerous contract test. With this in mind, the staff believe these contracts qualify for the premium allocation approach.
12. **Health Insurance Contract** – This one-year policy is designed to indemnify the insured against incurred losses covering virtually all kinds of expenses associated with medical care and related services. The contract states the total dollar limits	PAA

Type of Contract	***Measurement model that would result from applying the recommended eligibility criteria***
and specific benefits covered. The contract contains some method of cost sharing of medical costs with the contract holder through either co-payment plans, which specify a formula for the sharing of actual medical expenses between the insurer and the contract holder, or deductibles, which specify a dollar amount of medical expense the contract holder generally must pay before the insurance coverage begins, or both. For purposes of this example, assume a one-year term. The insurer has the right to fully underwrite the contract and re-price after one year.	
13. **Japanese Fire Insurance Contract (30-year)** – This policy provides the insured with coverage for loss or damage to assets, including a building and its contents, as a result of specified insured events for 30 years. These specified insured events include fire and explosion, lightning, windstorm, water damage, and theft. The amount payable to the policyholder depends on the type of insured event. The policy includes a savings component if the policyholder so chooses. The policy is sold in conjunction with the mortgage loan. The premiums are calculated using the applicable discount rate, and are level over the 30-year coverage period. For purposes of this example, assume the insurer cannot re-price the contract.	BBA

Appendix F: Difference between the premium allocation and building block approaches (as included in agenda paper 4B/74B discussed at the 20 October 2011 board meeting)

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

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

(b) recognises 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.

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. Many users think that premium and claim information are the basis for the key metrics needed to analyze 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.

The primary differences 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:

d. 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.

e. The premium allocation approach naturally generates premium revenue and claims expense information.[8]

The measurement difference means:

f. 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.

g. 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.

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 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.

[8] 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.