STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Premium Allocation Approach Mechanics		
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This paper reproduces, without change, agenda paper 3G/79G 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.

Purpose of the paper

1. The IASB's exposure draft *Insurance contracts* (ED) proposed a premium allocation approach for some short duration insurance contracts. The purpose of this paper is to discuss whether the premium allocation approach in the ED could be simplified by considering:

   (a) the requirement to discount the liability for remaining coverage and accrete interest, and

   (b) the treatment of acquisition costs.

2. This paper does not address:

   (a) eligibility criteria to use the premium allocation approach (see Agenda Paper 2A/78A),

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(b) mechanics of the onerous contract test (see Agenda Paper 7D/77D discussed at the 16 December 2011 meeting), or

(c) whether the premium allocation approach should be permitted or required (this topic will be addressed in a future meeting).

Summary of staff recommendations

Discounting and Interest Accretion of the Liability for Remaining Coverage

3. Some staff recommend that, consistent with the proposals in the revenue recognition ED, discounting and interest accretion should be required in the measurement of the liability for remaining coverage for contracts that have a significant financing component. These staff also recommend that, as a practical expedient (and consistent with the revenue recognition ED), insurers need not apply discounting or interest accretion if the coverage period of the contracts is less than one year.

4. Other staff recommend that the liability for remaining coverage should not be discounted and interest should not be accreted on the liability, regardless of the coverage period of the insurance contracts.

Acquisition Costs

5. Some staff recommend that the measurement of acquisition costs in the premium allocation approach should include directly attributable costs (for the FASB, limited to successful acquisition efforts only), consistent with the tentative decisions made for the building blocks approach. In addition, insurers should be permitted to expense directly attributable costs that are not incremental.

6. Other staff recommend that the measurement of acquisition costs in the premium allocation approach should be consistent with the proposals in the revenue recognition exposure draft, ie that

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

(b) insurers should be permitted to expense all acquisition costs if the coverage period is one year or less.

7. Finally, the staff recommend that, consistent with the model proposed in the revenue recognition project:

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

(b) Acquisition costs should be amortized in a manner 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).

Background

Premium Allocation Approach in the Exposure Draft

8. The premium allocation approach would require the insurer to measure its liability for remaining coverage ('pre-claims liability') separately from its liability for incurred claims ('claims liability'). The insurer would apply the building block approach for measuring the liability for *incurred claims*, but it would apply the premium allocation approach for measuring the liability for *remaining coverage*. The rationale given in the basis for conclusions accompanying the ED was that:

The Board proposes that the pre-claims liability arising from some short-duration contracts … 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.

9. Thus, the premium allocation approach proposed in the ED simplifies the measurement of the insurance contract liability for *remaining coverage (*previously referred to as the pre-claims liability). Instead of measuring that liability directly using current estimates of the expected cash flows, discounting the liability, adding a risk adjustment [IASB only] and recognising a residual/single margin, the premium allocation approach measures the liability by reference to the premium at inception.

10. In the ED, the proposed premium allocation approach for measuring the liability for remaining coverage involved:

    (a) initially measuring the obligation for remaining coverage at the premium received at initial recognition, plus the expected present value of future premiums less acquisition costs;

    (b) recognising a liability for the remaining coverage, equal to the amount described in (a) less the expected present value of future premiums, if any;

    (c) accreting interest on the liability (see paragraph 11);

    (d) reducing the obligation over the coverage period on the basis of the passage 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); and

(e) recognising an additional liability if contracts are onerous, i.e. if the present value of the fulfilment cash flows relating to future claims (measured applying the building block approach and including a risk adjustment) exceeds the carrying amount of the obligation for remaining coverage. An additional liability would be recognised for the excess.

11. One of the reasons the ED originally proposed to require discounting and the accretion of interest for the liability for remaining coverage was to ensure consistency with the proposals in the revenue recognition project. The recently released revenue recognition exposure draft states:[1]

> *In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract.*
>
> *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 when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services*
>
> *b. Whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction*
>
> *c. The interest rate in the contract and prevailing interest rates in the relevant market.*

[1] Appendix A contains the relevant language from the recently released revenue recognition exposure draft.

Feedback Received

12. The vast majority of respondents supported the proposal to include in the insurance standard a premium allocation approach for some contracts. However, many respondents expressed concerns that the approach proposed in the exposure draft was over-engineered in some respects and tried to stay too close to the building block approach. Unnecessary complications—for example, requirements for discounting, interest accretion and onerous contract tests—would defeat the objective of the approach.
13. Some respondents suggested that the premium allocation approach applied in the standard should be more like the 'Unearned Premium Reserve' (UPR) approach applied by some insurers at present. When applying the UPR approach, insurers generally ignore the effects of the time value of money, 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.

Staff analysis

14. In response to this feedback, the staff considered possible changes to the premium allocation approach proposed in the ED that would simplify the measurement of the liability for remaining coverage.
15. The boards have reached the following tentative decisions that are relevant to the measurement and presentation of the liability for remaining coverage:
    (a) 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) The statement of financial position should present the liability for remaining coverage separate from the liability for incurred claims.

(c) The liability for remaining coverage should be presented gross of other rights and obligations (e.g., receivables) in the statement of financial position

(d) An insurer should perform an onerous contract test if facts and circumstances indicate that the contract is onerous.[2] Onerous contracts identified in the pre-coverage period should be measured on a basis that is consistent with the measurement of the liability recognized at the start of the coverage period. Similarly, onerous contracts identified under the premium allocation approach should be measured on a basis that is consistent with the measurement of the liability for claims incurred. We will discuss in a future meeting the interaction of this decision with the tentative decision to introduce a practical expedient that would not require discounting for incurred claims that are expected to be paid within 12 months of the insured event.

(e) Premiums, claims, benefits and the gross underwriting margin should be presented in the statement of comprehensive income (the boards have not decided whether this information will be disaggregated from similar volume information for contracts accounted for using the building block approach).

16. The Boards also tentatively decided to require discounting of the liability for incurred claims for all non-life long-tail claims. However, the Boards also tentatively agreed that discounting of insurance liabilities should not be required when the effect of discounting would be immaterial and provided a practical expedient that would permit insurers not to discount portfolios where the incurred claims are expected to be paid within 12 months of the insured event, unless facts and circumstances indicate that payments will no longer occur within 12 months.

[2] An insurance contract is onerous if the expected present value of the future cash outflows from that contract [plus, for the IASB, the risk adjustment] exceeds: (a) the expected present value of the future cash inflows from that contract (for the pre-coverage period), or (b) the carrying amount of the liability for the remaining coverage (for the premium allocation approach).

17. The staff have considered further simplifications to the premium allocation approach in the following areas:

    (a) Discounting of the liability for remaining coverage and interest accretion (discussed in paragraphs 21 – 59);

    (b) Treatment of acquisition costs (discussed in paragraphs 60 – 104);

18. Some of the simplifications considered would align the premium allocation approach in the insurance contracts standard more closely with the revenue recognition proposals. Appendix B contains a table that compares and contrasts current US GAAP, the measurement approach proposed in the ED/DP, and the measurement approach under the building block approach with the revenue recognition proposals. It also evaluates how the alternatives considered by the staff in this paper compare to the revenue recognition proposals.

19. Aligning the premium allocation approach more closely with the proposals for revenue recognition would have advantages.

    (a) It would help to streamline IFRSs and U.S. GAAP, minimising differences between the accounting models for different types of contracts with customers (i.e. insurance and other). Minimising these differences would take pressure off the scope of the insurance contracts standard.

    (b) The overall approach proposed for the revenue standard is similar to the UPR approach applied by some insurers at present. Consequently, aligning the premium allocation approach in the insurance contracts standard with the requirements of the revenue standard would incorporate some of the changes requested in the comment letters.

20. However, aligning the premium allocation approach more closely with the proposals for revenue recognition could also have some disadvantages. Some staff argue that aligning the premium allocation approach with the revenue recognition proposals would not simplify the building block approach sufficiently and would make the approach operationally difficult to apply. In addition, because it reflects the time value of money when a financing

component is present, it could also impact the inputs to some of the key performance indicators used by investors to evaluate insurers.

Discounting of the liability for remaining coverage and interest accretion

Proposals in the Exposure Draft

21. In measuring the liability for remaining coverage (previously referred to as the pre-claims liability) the IASB's ED states that any expected future premiums should be discounted.

22. Paragraph 59 of the IASB's ED indicates that an insurer shall accrete interest on the carrying amount of the liability for remaining coverage.

23. Paragraph 106 of the FASB's DP indicates that the board had not determined whether interest would be accreted on the carrying amount of the liability for remaining coverage.

Staff Analysis

24. The staff considered the following alternatives regarding whether to include discounting and interest accretion in the measurement of the liability for remaining coverage:

    (a) Alternative A: The liability for remaining coverage should not be discounted and interest should not be accreted on the liability, regardless of the coverage period of the insurance contracts.

    (b) Alternative B: Require discounting and interest accretion in the measurement of the liability for remaining coverage for contracts that have a significant financing component. As a practical expedient, do not require discounting and interest accretion if the provision of coverage is for one year or less.

25. Both of the alternatives in paragraph 24 would depart from the building block approach, and this could impair comparability with other insurance contracts. However, Alternative B is consistent with the proposals in the revenue recognition exposure draft. The staff believe both alternatives would address

respondents' views that the premium allocation approach proposed in the ED was over-engineered and simplify the premium allocation approach, albeit to different degrees.

26. We discuss these alternatives below.

Alternative A – The liability for remaining coverage should not be discounted and interest should not be accreted on the liability, regardless of the coverage period of the insurance contracts.

27. The staff considered whether insurers should measure the liability for remaining coverage at the premium, if any received at initial recognition, plus the undiscounted sum of expected future premiums, if any, that are within the boundary of the existing contract.

28. Some staff believe that:

    (a) The effect of discounting and accretion of interest may not be significant to contracts eligible for the premium allocation approach. Consequently, the costs of discounting and interest accretion will outweigh the benefits.

    (b) Discounting and interest accretion of the liability for remaining coverage will introduce significant complexity into the premium allocation model.

    (c) Discounting and interest accretion may not provide decision useful information to users of insurers' financial statements.

29. The following sections discuss each of these issues.

The effect of discounting and interest accretion may not be significant

30. The effect of discounting and accretion of interest could be significant to contracts that apply the premium allocation approach only if a significant financing components could be present in those contracts. The staff considers whether that is the case in the following paragraphs. If no significant financing component exists, then requiring discounting or the accretion of interest would increase complexity for little or no benefit. In order to determine if a significant financing component exists, the staff have considered whether the

factors included in the revenue recognition exposure draft for assessing the presence of a significant financing component in revenue contracts are applicable to insurance contracts within the scope of the premium allocation approach and/or should be modified to apply to insurance contracts. These are set out in paragraph 11.

31. When analysing how the decisions made in the revenue recognition proposals relate to insurance we note a significant difference, ie that under revenue recognition an entity will normally record either:

    (a) a receivable (if the customer pays after the provision of goods or services) on which interest is accrued; or

    (b) a contract liability (if the customer prepays) on which interest is accreted.

    Because there is normally only a receivable or a contract liability (not both), interest accretion and discounting has a net impact on the statement of comprehensive income.

32. In the case of insurance contracts, the insurer recognises *both* a receivable and a liability for remaining coverage (unless the entire premium is paid upfront). Interest is accrued on the receivable and accreted on the liability at the same time and at the same rate and thus the impact on the statement of comprehensive income is offset. Appendices C and D illustrate this effect.

33. If there is a significant timing difference between receipt of initial premium and the coverage provided then criterion (a) (expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services) in paragraph 11 might indicate that a significant financing component exists. The staff note that insurance contracts are in general pre-paid and if the policyholder does not pay the premium when due, the policy lapses. Therefore, it is unlikely that payment by the policyholder will occur significantly after the time the coverage is provided.

34. Criterion (a) could apply, if the insurer receives premium prior to when it performs under the contract (which is when that premium would be earned)[3]. However, the staff believe that many of the contracts that will qualify for the premium allocation approach will be of short duration. Consequently, the period of time between payment and performance under the contract is likely to be short.

35. Criterion (b) (ie whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction) above could be relevant if an insurer charged a policyholder either an explicit or implicit fee[4] for paying premium over time as opposed to paying the premium up front. This fee could amount to a significant amount of interest income that could affect the pattern of revenue recognition during the pre-claims period and the total amount of premiums/revenue recognised over the coverage period. The staff note that if the policyholder were to cancel the contract, the insurer would typically owe the policyholder the unearned amount based on the premium that was initially paid, without regard to any implicit interest earned on the cash received.The staff also note that if a significant financing component is present because an insurer charges an explicit fee. Both alternatives would capture the financing component of this transaction as other income separate from the insurance underwriting results.

36. With regard to criterion (c) in paragraph 11 (ie interest rate in the contract and prevailing interest rates in the relevant market), insurance contacts typically do not contain a stated interest rate. If an insurance contract does not require a policyholder to pay a fee for paying premiums over time, then the interest rate is implicit in the price of the product and thereby difficult to determine. Criterion (c) is included in revenue recognition for contracts with customers to

[3] In the revenue recognition proposals, the boards decided not to exempt entities from accounting for the time value of money effects of advance payments because ignoring the time value of money could substantially skew the amount and pattern of profit recognition if the advance payment is large and occurs well in advance of the transfer of the goods or services to the customer.
[4] There is diversity in practice. In the US, typically there is no fee or it is nominal, such as $6, to cover processing costs. In the UK there are certain contracts that charge a percentage of the premium, i.e., 10% as a fee.

indicate that if prevailing market rates of interest are high and the customer is paying in advance or arrears, it may indicate the presence of a significant financing component. It is also included to address the possibility that a difference between the interest rate in the contract and the interest rate in the prevailing market could constitute a non-repayable loan (or a cross-subsidy and a finance charge) between an entity and a customer, also indicating a significant financing component.[5]

Requiring discounting and interest accretion will introduce significant complexity

37. Staff supporting alternative A note that, accreting interest when there is a timing difference between receipt of the initial premium and provision of coverage could add complexity to the model that some believe is unwarranted because it could be difficult to determine the amount that should be accreted. The amount to accrete would not be difficult to determine if the entire premium was received upfront, but most insurance contracts allow policyholders to pay premiums in various increments, e.g., semi-annual, quarterly, monthly, etc. The terms of typical contracts do not prohibit a policyholder from pre-paying premiums. For example, if a policyholder pays premium at the beginning of each quarter, any additional pre-payment might cause the contract to meet the significant financing criteria, thus requiring accretion on the entire liability for remaining coverage. The insurer would in effect be accreting interest on the non-pre-paid elements of the liability for which there is no financing component.

38. Some may question whether interest should be accreted only on the prepaid amount. The principle of interest accretion would require accretion on the whole of the liability for remaining coverage and not just the prepaid amount and that is consistent with the proposals in the ED. However, if interest were to be accreted only on the prepaid amount, it would be operationally complex to apply as the amount of financing would be reduced over the prepaid period

[5] Criterion (b) does not address the issue of reasonable rates of interest within a contract between an entity and a customer; it only intended to identify contracts for which the amount of consideration paid would be different on the basis of timing of customer payment as a result of industry credit terms.

(e.g., the quarter) and interest accretion would be reduced, then when the next installment is paid, the interest accretion would increase and then be reduced, etc. If the insurer were to be required to accrete interest only on the prepaid amount, there would be complexity in determining the amount that is "prepaid" each reporting period, how that amount is earned over time to determine the financing component, and therefore, the amount of the liability that should accrete interest. There would be potentially no benefit from this complexity. There would be further complexity, if the boards followed the proposals in the revenue recognition ED to determine whether a significant financing component exists at the individual contract level. The staff believe the issues described in paragraph 37 would be exacerbated by this requirement and that the number of individual contracts and the potential system modifications required would be unduly burdensome and result in costs that would exceed the benefits.

39. Staff supporting Alternative A have considered whether the practical expedient in Alternative B (requiring discounting and interest accretion in the measurement of the liability for remaining coverage *only* for contracts that have a coverage period greater than one year, and have a significant financing component) would alleviate enough complexity in the model. However, these staff note that the practical expedient still requires discounting for the liability for remaining coverage for contracts that have a coverage period longer than one year, where part of the premium is prepaid. For example, an insurer may receive each year's premium at the beginning of each fiscal year for a multi-year insurance contract (e.g., a three-year surety contract). This would mean that prepayment of any part of the premium for that contract would result in the insurer discounting to the entire liability for remaining coverage, even though there are still two years of receivable recorded as well (i.e. premium associated with those years has not been received). So while the practical expedient will reduce the number of contracts for which significant financing would need to be determined, insurers would need to have separate systems for contracts based on duration. They do not have

these systems at present, nor do they necessarily group these contracts separately from other contracts for measurement purposes.

Requiring discounting and interest accretion does not provide decision useful information

40. Staff supporting Alternative A are concerned that accreting interest on the liability for remaining coverage when the premium is pre-paid changes the amount that would be presented as earned premium. This is also the case in the revenue recognition proposals for contracts where a significant financing component is present. The amount of cash received does not equal the amount of revenue recognised because it is adjusted to reflect the time value of money. Paragraph 58 in the revenue recognition exposure draft states,[6]

> *In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract. The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognize revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer.*

41. As previously noted, insurers do not necessarily charge a different premium if the policyholder pays upfront or over time. However, there may be implicit financing in the pricing of the premium). Insurers price non-life contracts (presumably within the scope of the premium allocation approach) to cover expected cash outflows. The short-duration of many of these contracts means that many insurers do not receive meaningful additional financing fees from policyholders.. In these cases, to require the interest to be accreted on the liability to reflect "…what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that

[6] Paragraph 61 of the revenue recognition exposure draft states, "to adjust the promised amount of consideration to reflect the time value of money, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception."

they are transferred to the customer…" would not accurately portray the characteristics of the contract in some of the staff's view.

42. Appendix D contains an analysis showing that when the time value of money is reflected for pre-paid premiums, the premiums earned amount is higher than the premiums written. This analysis also shows that the interest expense amount decreases over time, as the premiums earned from financing increases. Although these amounts result in the same total as of the end of the 24th month (they eventually offset each other), the timing is different, as shown in the data table in Appendix D. This reflects that the implicit deposit in the premiums generates higher interest expense at the beginning of the contract than at the end and that this interest expense is used to pay part of the premiums the insurers would otherwise have charged. That effect would also be shown if the insurer had charged a premium that reflected the time value of money, invested those cash receipts to earn the discount rates implicit in the pricing and paid the premiums from that account.

43. The effect shown in Appendix D would be a significant change from current practice which does not accrete interest on premiums written. Premiums earned is a key performance indicator for the insurance industry and is a key input into the calculation of loss ratios which is also a key performance indicator for the insurance industry.   Staff supporting Alternative A note that discounting and accreting interest would add complexity for these users, as the adjusted premiums earned amount may be misleading and troublesome to separate from actual premiums earned. (Staff supporting Alternative B believe that believe that effect of discounting and accretion of interest reflects an economic effect that would otherwise be ignored, as discussed in paragraphs 45-48).

44. In the ED/DP the boards tentatively decided to recognize in the statement of comprehensive income or the notes thereto the premium revenue gross of the amortization of acquisition costs. The staff believe that the boards' decision was based on their recognition of the significance of premiums earned for the insurance industry for short duration contracts. In addition, during the redeliberations, the boards indicated a preference for an example presentation

model that would present premiums due (the amount of premium charged to policyholders during the year) in the statement of comprehensive income. It would be inconsistent with that presentation if an insurer recognised an amount in excess of the premiums charged for contracts measured using the premium allocation approach.

45. Because of the significance of premiums earned to the insurance industry, should the boards decide to accrete interest on the liability for remaining coverage to reflect the time value of money when premiums are pre-paid, staff supporting Alternative A would recommend that the effect of interest accretion on the premiums earned during the period should be included in a separate line item from premiums earned. Staff supporting Alternative B believe that to do so would be inconsistent with the proposals in the revenue recognition exposure draft and misrepresent the premiums presented in the statement of comprehensive income by excluding from them implicit cross-subsidies between the amount, if any, charged to or from the policyholder for finance and the amount charged to the policyholder for insurance coverage.

Comparison with building block approach

46. The staff considered the differences that would be generated between the premium allocation approach and the building block approach if discounting and accretion of the liability for remaining coverage is not required. Discounting future premiums decreases the residual or single margin in the building block approach. The interest would be recognised over the period the insurer expected to receive the premiums (which would generally be no longer than the coverage period) and the residual margin (in the IASB's tentative decisions) would be amortised over the coverage period, thus offsetting one another (this does not consider unlocking of the residual margin). The single margin (in the FASB's tentative decisions) would be amortised as the insurer is released from risk, which is based on the reduction in uncertainty of the variability of the cash flows which would provide a partial if not full offset. The staff note that the net effect of discounting and accretion in the building block approach would also net to zero and therefore do not think it will be

confusing to users if the premium allocation approach does not discount and accrete interest on the liability for remaining coverage because the net effect in both cases is the same.

Alternative B - Require discounting and interest accretion in the measurement of the liability for remaining coverage only for contracts that have a significant financing component

47. As previously discussed, accreting interest on the liability for remaining coverage changes the amount that would be presented as earned premium so that it reflects the time value of money. Accreting interest would be consistent both with the proposals in the revenue recognition ED and with the measurement of the liability under the building block approach.

48. Staff supporting alternative B argue that insurers and investors are not indifferent to the timing of cash flows, and so measuring an insurance liability with a significant financing component using undiscounted cash flows and not accreting interest on that liability would not faithfully represent the insurer's financial position and would be less relevant to users. This is the case regardless of whether financing is explicit, as described in paragraph 35 or implicit in the pricing of the contract. Consequently, staff supporting Alternative B do not support removing the requirement to discount and accrete interest for all contracts accounted for under the premium allocation approach.

49. Furthermore, staff supporting Alternative B note that requiring discounting and interest accretion in the measurement of the liability for remaining coverage only when contracts that have a significant financing component would align the premium allocation approach more closely with the recently released revenue recognition exposure draft. This would minimise the differences between the accounting models for different types of contracts with customers (i.e. insurance contracts versus other contracts) as discussed in paragraph 19. Consistency with revenue recognition would reduce the possibility of accounting arbitrage because the treatment of discounting would be the same under both the revenue recognition standard and the insurance contracts standard.

50. Alternative B would simplify the premium allocation approach proposed in the ED. It would likely eliminate discounting and interest accretion for most short-duration non-life insurance contracts, which will presumably be within the scope of the approach, without changing the measurement for those contracts, as the effect of discounting may not be significant over such a short period. In addition, because discounting and accretion would not apply when there is no significant financing component, alternative B would also remove the requirement to discount for many contracts that are prepaid on a monthly or quarterly basis as the financing component of such contracts is unlikely to be significant.

51. For these reasons, staff supporting Alternative B recommend reflecting the time value of money in premiums earned for contracts with a significant financing component.

Practical expedient for determining there is no significant financing component

52. In the following paragraphs, the staff consider whether to incorporate in Alternative B a practical expedient to eliminate discounting and interest accretion if the provision of coverage is one year or less.

53. The recently released revenue recognition exposure draft introduced a practical expedient, which 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.*

54. One advantage of exempting an entity from discounting and interest accretion arising from short-term contracts (less than one year) is that it would simplify the standard. An entity would not be required to:

(a) conclude whether those contracts contain a significant financing component; or

(b) determine the interest rate that is implicit within those contracts.

55. However, a practical expedient of one year could produce arbitrary outcomes in some cases. For example, the time value of money could be material if a short-term contract has a high implicit interest rate. Also, this approach could result in inconsistent application of discounting within the premium allocation approach. For example, a contract with a coverage period of 18 months that is accounted for under the premium allocation approach would be required to be discounted if the contract contain a significant financing component; a similar contract with a coverage period of 12 months would not. The staff note that this is also the case with the practical expedient introduced in the revenue recognition proposals.

Staff recommendation – Discounting and interest accretion

56. When considering the concerns from respondents, the complexity that discounting would add, and the impact on the financial statements (or lack of net impact on the financial statements) staff supporting Alternative A do not believe an insurer should adjust the liability for remaining coverage (which is equal to the promised amount of consideration or premium) to reflect the time value of money because:

(a) The effect of discounting may not be significant to contracts of the type accounted for under the premium allocation approach. Consequently, the costs associated with requiring discounting and interest accretion will outweigh the benefits.

(b) Requiring discounting and interest accretion of the liability for remaining coverage will introduce significant complexity into the premium allocation model

(c) Requiring discounting and interest accretion may not provide decision useful information to users of insurers' financial statements.

57. Staff supporting Alternative B believe that discounting and interest accretion should be required in the measurement of the liability for remaining coverage:

    (a) 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

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

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

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

    (b) As a practical expedient, insurers need not apply discounting or interest accretion if the coverage period of the contracts is less than one year.

58. These staff believe that reflecting the time value of money (if it is significant) in the measurement of insurance liabilities and thus the key performance indicators provides useful information to users of financial statements. However, because requiring discounting/interest accretion increases the complexity of the premium allocation, these staff support the introduction of a practical expedient for contracts with a coverage period of less than one year.

59. Staff supporting alternative B also note that:

    (a) Many of the contracts that qualify for the premium allocation approach do not have a significant financing element and/or have a coverage period of less than one year.

    (b) This alternative is consistent with the proposals in the revenue recognition ED.

Question 1 – Discounting and interest accretion
Alternative A

Do the boards agree that the measurement of the liability for remaining coverage should not be discounted and interest should not be accreted on the liability?

Or

Alternative *B*

Do the boards agree that:

(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?

(b) 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?

Treatment of acquisition costs

Proposals in the Exposure Draft/Discussion Paper

60. Paragraph 56 of the IASB's ED proposes that the liability for remaining coverage is measured as the premium received at initial recognition plus the expected present value of future premiums, if any, which are within the boundary of the existing contract; less the incremental acquisition costs.

61. Paragraph 75 of the ED proposes that for contracts measured using the premium allocation approach, an insurer disaggregates in the statement of comprehensive income or in the notes the amortization of incremental acquisition costs and premium revenue, determined as the gross release of the pre-claims obligation, grossed-up for the amortization of incremental acquisition costs.

62. Paragraph 106 of the FASB's DP indicates that the FASB had not determined how to treat incremental acquisition costs and whether they would reduce the liability for remaining coverage.

Related Tentative Decisions

63. At the February 1, 2011 meeting, the boards tentatively decided that, for contracts measured using the building block approach, the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts.

64. During the February 18, 2011 meeting, the boards tentatively decided to measure an insurance contract using an explicit, unbiased, and probability-weighted estimate (that is, expected value) of the future cash outflows, less future cash inflows that will arise as the insurer fulfills the insurance obligation. Implicit in this decision is that acquisition costs are part of the expected cash outflows.

65. During the June 13, 2011 meeting the boards tentatively decided that, for contracts measured using the building block approach, the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all of the direct costs that the insurer will incur in acquiring the contracts in the portfolio such as:

    (a) Direct costs of contract acquisition/origination.

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

        (i) Underwriting,

        (ii) Policy issuance and processing,

        (iii) Medical and inspection,

        (iv) Sales force contract selling,

    (c) Costs directly related to the activities in (b), and

    (d) Direct response advertising.

66. The FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to those costs related to successful acquisition efforts.

67. During the April 27, 2011 meeting, the IASB tentatively decided that an insurer should include acquisition costs in the measurement of the insurance contract liability under the premium allocation approach. The FASB did not vote on this issue.

Respondent Feedback on acquisition costs in the premium allocation approach

68. A few respondents suggested that insurers be permitted to expense some acquisition costs as incurred, rather than including those costs in the expected cash flows.

69. Additional feedback indicated that, for particular lines of business, the majority of the acquisition costs are comprised of commissions and premium taxes. For many of these contracts the acquisition costs are deferred and amortized in a short time period (for example, if the coverage period is less than one year the acquisition costs are determined and recognised as an asset and amortized within one year). The systems and other costs required to determine the expenses related to other acquisition related activities that would meet the criteria to be included in the cash flows, such as underwriting and policy issuance exceed the benefit that would be provided by including acquisition costs in expected cash flows.

70. A few other respondents indicated support for an option to expense all acquisition costs as incurred, especially if they would not be significant, e.g. if the contract is short.

71. Some respondents expressed a preference for treating acquisition costs as an asset rather than a reduction to the liability for remaining coverage.

Staff Analysis

72. Agenda Paper 3B/56B from the February 2, 2011 joint board meeting indicated that the staff would consider at a future meeting the applicability of the decisions reached on acquisition costs at that meeting to the premium allocation approach. Consequently, the staff have considered the following alternatives for the treatment of acquisition costs for the premium allocation approach:

(a) Measurement (costs that should be included as acquisition costs)

   (i) Directly attributable costs (for the FASB limited to successful acquisition efforts only), consistent with the tentative decisions made under the building blocks approach; or

   (ii) Incremental costs (this would be consistent with the revenue recognition proposals)

(b) Permit insurers to expense:

   (i) Acquisition costs that are directly attributable but are not incremental; or

   (ii) All acquisition costs if the contract coverage period is one year or less, consistent with the revenue recognition proposals.

(c) Recognise acquisition costs as an asset (and thus present the liability for remaining coverage gross of acquisition costs), consistent with the revenue recognition proposals

Measurement (which acquisition costs to include)

73. The revenue recognition exposure draft states that "the incremental costs of obtaining a contract are those costs that an entity incurs in its efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (for example, a sales commission)."

74. Applying this definition to insurance, incremental costs would include acquisition costs that are directly related to the acquisition of a portfolio of insurance contracts that the insurer would not have incurred if the insurer had not issued those insurance contracts. The staff believe this would be equivalent to determining acquisition costs at the contract level and would in practice include only commissions and premium taxes. Many respondents believed this was too limiting for insurance contracts and would not include costs integral to the acquisition of new and renewal business and would result in differences between insurers with different distribution systems.

75. The boards discussed which acquisition costs should be included in the cash flows of an insurance contract several times during 2011 (February 2, March 2, and June 15, 2011). Also at the June joint board meeting, Agenda Paper 3F/70F presented the cross-cutting issues comparing the boards' tentative decisions on insurance with those on revenue recognition and leases as well as the current financial instruments standard. The result from those meetings was that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all of the direct costs that the insurer will incur in acquiring the contracts in the portfolio.

76. Direct costs would include all acquisition costs that are directly related to the acquisition of a portfolio of insurance contracts. This would include compensation (and compensation related costs) for and costs incurred by the people performing functions directly related to acquiring new or renewal contracts including underwriting, sales force contract selling, medical and inspection, and policy issuance, as well as other third-party costs related directly to the insurer's acquisition such as medical and inspection fees.

77. The primary rationale behind the boards' decision to determine acquisition costs at the portfolio level to be included in the present value of fulfillment cash flows included:

    (a) All other measurements in the model are at the portfolio level, and that is consistent with how insurers price and manage their business;

    (b) To eliminate differences among insurers who have different distribution systems (i.e., whether the entity performs contract acquisition services in-house and incurs internal agent commission and or salaries or sources services externally and pays commissions to third-party agents or uses direct response advertising and incurs related costs);

    (c) To include costs that are not linked to a specific contract such as underwriting, medical and inspection, and policy issuance.

78. Some staff believe that the boards' tentative decisions regarding the measurement of acquisition costs are applicable to all insurance contracts and should not be different because of the use of a different model to measure the liability for remaining coverage. Creating differences in the measurement of acquisition costs creates additional complexity and would be an additional item that users of the financial statements would need to understand and keep in mind when analyzing insurance companies. Today's guidance regarding the determination of costs that are included as acquisition costs does not differ based on type of insurance contract or the accounting model applied.

79. These staff acknowledge that the premium allocation approach includes concepts from revenue recognition and can be used to determine potential further revisions to the premium allocation approach. However, these staff believe that a wholesale adoption of the revenue recognition model would not be appropriate and could have unintended consequences.

80. Other staff believe that the treatment of acquisition costs in the premium allocation approach should be the same as under the revenue recognition model because aligning the premium allocation approach to the revenue recognition proposals would streamline IFRSs and US GAAP by minimizing the differences between the accounting models for different types of contracts with customers (ie insurance contracts and other). This would mean that acquisition costs for insurance contracts that are accounted for under the premium allocation approach would include incremental costs that are directly related to the acquisition of a portfolio of insurance contracts and that the insurer would not have incurred if the insurer had not issued those insurance contracts.

81. The requirements of revenue recognition would be simpler to apply than the requirements of the building block approach. Incremental costs would be easier to identify and measure than other direct costs. For example, there would be no need to identify and allocate non-incremental direct costs, such as the costs of time spent by employees on underwriting activities.

82. It can also be argued that the differences between direct acquisition costs and incremental acquisition costs are not material for some types of contracts that would be accounted for using the premium allocation approach. It is presumed that the premium allocation approach would be applied primarily to non-life insurance contracts for which a significant acquisition cost is commissions.[7]

Permit expensing additional costs

83. The staff considered whether there should be an option for insurers to expense some or all of the acquisition costs that would otherwise be reflected in the measurement of the insurance contracts liability (or presented as a separate asset). The staff considered two alternatives, permit insurers to expense:
    (a) Acquisition costs that are directly attributable but are not incremental
    (b) All acquisition costs if the coverage period is one year or less.

84. The staff that support including only incremental costs in the measurement of acquisition costs support including a practical expedient similar to that included in the revenue recognition exposure draft:

    > *As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.*

85. However, some staff do not support the option to expense all acquisition costs for insurance contracts that have a coverage period of one year or less. As previously noted in this paper, those staff believe that a one-year cut-off is arbitrary and similar contracts within a portfolio of insurance contracts could have different accounting. they believe if the boards adopt an option to expense all acquisition costs, it should be for all contracts within the premium allocation approach.

86. The staff that support maintaining the boards' tentative decision in the insurance project regarding the measurement of acquisition costs (direct costs

[7] For personal lines of business, commissions are the most significant acquisition cost.

that the insurer will incur in acquiring the contracts in the portfolio) have considered whether insurers applying the premium allocation approach should be permitted to expense some costs that otherwise would meet the criteria to be included in the measurement.

87. These staff note that permitting the expensing of additional costs would be inconsistent with the building block approach. However, the staff believe that implementing this approach is more appropriate in the case of shorter duration contracts where the internal underwriting costs are not as significant.

88. In practice, several insurers that apply a short-duration model today capitalize external incremental acquisition costs and expense all internal incremental acquisition costs as incurred. Tracking external incremental acquisition costs, such as commissions and premium taxes, which are the most significant component of acquisition costs for the majority of the types of contracts that would apply the premium allocation approach, is straightforward. However, the costs to perform regular cost studies and to modify systems to track internal incremental acquisition costs such as underwriting and policy issuance, that will reverse over a short coverage period, may not outweigh the benefits.

89. As such, these staff believe that insurers should be given an option to expense non-incremental acquisition costs, resulting in only incremental acquisition costs being included in the measurement, consistent with revenue recognition. Nevertheless, these staff do not believe expensing should be the requirement, as some types of contracts that are presumed to meet the criteria to apply the premium allocation approach do have significant underwriting costs, especially for large commercial contracts. This option should be applied at the same unit of account as that which the single/residual margin is earned and the onerous contract test is performed.

Question 2 – 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)?

Presentation

90. To maintain consistency between the premium allocation approach and the building block approach, the boards proposed in the ED that the liability for remaining coverage at initial recognition be reduced by the acquisition costs. Although acquisition costs would reduce the liability for remaining coverage, paragraph 75 of the IASB's ED proposes that an insurer disaggregate in the statement of comprehensive income or in the notes the amortisation of acquisition costs and premium revenue, determined as the gross release of the liability for remaining coverage, grossed-up for the amortisation of acquisition costs.

91. Paragraph 136 of the IASB's ED Basis for Conclusions explains that the boards considered the current accounting models that measure insurance liabilities initially at the amount of premium received, with deferral of acquisition costs. Such models treat acquisition costs as representing the cost of a recognisable asset. The boards believed that the pressure to recognize such an item as a separate asset arises from an overstatement of the insurer's

obligation. Some have asserted that deferred acquisition costs do not meet the definition of an asset. In addition, deferring acquisition costs as an asset would report an asset that either (a) does not exist (if the insurer recovers acquisition costs from cash already received) or (b) relates to future cash flows that should be included in the measurement of the contract.

92. In deciding to include acquisition costs as contractual cash flows, the boards believed an insurer typically charges a policyholder a price that the insurer regards as sufficient to compensate for undertaking the obligation to pay for insured losses and the cost of originating the contract. As such, a faithful representation of the remaining obligation would not include the portion of the premium that paid for the acquisition costs. If the contract pricing is insufficient to recover the acquisition costs, a loss would arise at initial recognition because the residual (or single) margin could not be negative.

93. However, some board members have voiced the concern that reducing the insurance liability for acquisition costs and subsequently decreasing the liability as result of the payment of acquisition costs, is not a faithful representation of the obligation the insurer has to the policyholder and the trending (development) of that liability. Therefore, these board members believe recording the insurance liability gross of deferred acquisition costs would be a more faithful representation of the obligation.

94. The ED proposes that for contracts measured using the premium allocation approach, an insurer disaggregates in the statement of comprehensive income or in the notes the amortization of incremental acquisition costs and premium revenue, determined as the gross release of the pre-claims obligation, grossed-up for the amortization of incremental acquisition costs. Presenting the acquisition costs as an asset separate from the liability for remaining coverage would better link the statement of financial position with the statement of comprehensive income.

95. Since the IASB's ED was released, in the revenue recognition exposure draft, the boards propose:

An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs, subject to the practical expedient.

96. While recognising acquisition costs as an asset would be consistent with the proposed treatment in accordance with the revenue recognition exposure draft, this would be different from the presentation for insurance contracts that apply the building block approach.. In addition to consistency with revenue recognition, this approach would also simplify the premium allocation approach in line with respondent concerns.

97. The staff note that although some of the following discussion regarding recording acquisition costs as an asset could pertain to both the building block approach and the premium allocation approach, the staff focus and recommendation here relate only to insurance contracts in the scope of the premium allocation approach.

98. Users indicated that information about the amount and amortization of acquisition costs is helpful in analyzing insurance entities. Although this information will be provided in (a) the roll-forward of the liability for remaining coverage, and (b) the amortization of the acquisition costs in the statement of comprehensive income under the current insurance proposals, several users have indicated their preference to record the acquisition costs as an asset.

99. The staff believe the primary reason for this view is that the liability for remaining coverage represents the volume of premiums that have been written but not yet earned and therefore is an indicator of growth trends or declines in future income. The boards have acknowledged that the full amount of premium charged should be recognized as premium earned in their tentative decisions (in the IASB ED and the FASB DP) to recognize premium revenue, determined as the gross release of the liability for remaining coverage, separate from the amortization of acquisition costs included in the liability for remaining coverage, in the statement of comprehensive income or the notes thereto.

100. In addition, one of the key performance indicators for users of non-life financial statements is underwriting results, which indicate whether the premium is sufficient to cover losses, expenses to process the claims, and expenses to acquire the business. Recognizing the acquisition costs separately from the liability for remaining coverage allows users to more easily calculate underwriting results and determine whether the premiums are sufficient to cover the losses and the expenses not yet recognized.

101. Based on this analysis, the staff recommend that the acquisition costs for insurance contracts measured using the premium allocation approach should be recognised as an asset in an insurer's statement of financial position.

102. This is consistent with the boards' decisions in the revenue recognition proposals.

103. The staff also believe that the acquisition costs should be amortized in a manner consistent with the boards' tentative decisions on reducing the liability for remaining coverage at the 27 April 2011 joint board meeting: the insurer should reduce the measurement of the liability for remaining coverage over the coverage period as follows:

    (a) On the basis of time, but

    (b) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

104. If the measurement of acquisition costs were to be the same as under the building block approach, and there were to be no options to expense those costs, using the same basis to amortise the deferred asset and unwind the single margin/residual margin would result in the same answer as the building block approach.

Question 3 – 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)?

Appendix A – Excerpts from the Revenue Recognition Exposure Draft

Below are excerpts from the recently released Exposure Draft on Revenue Recognition. While the references are from the FASB's proposed ASU draft, the wording is consistent with the IASB's exposure draft.

Time value of money

605-10-30-10 In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract. The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognize revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer. If the promised amount of consideration differs from the cash selling price of the promised goods or services, then the contract also has a financing component (that is, interest either to or from the customer) that may be significant to the contract.

605-10-30-11 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 when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
b. Whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction
c. The interest rate in the contract and prevailing interest rates in the relevant market.

605-10-30-12 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.

Incremental Costs of Obtaining a Contract

340-40-25-4 An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs, subject to the practical expedient in paragraph 340-40-25-7.

340-40-25-5 The incremental costs of obtaining a contract are those costs that an entity incurs in its efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (for example, a sales commission).

Appendix B: Comparison of insurance measurement approaches to revenue recognition proposals

	Unearned Premium Reserve Approach[8]	Measurement proposed in the ED/DP	Measurement under the Building Block Approach	Revenue recognition proposals	Alternatives considered by staff
Insurance liability for remaining coverage (paragraphs 21 – 59)	Unearned premium reserve equal to premiums charged for the unexpired coverage period	Pre-claims obligation - Premium, if any, received at initial recognition, plus the expected present value of future premiums, if any	Expected present value of the fulfilment cash flows.	In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract. 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.	Measure the liability for remaining coverage at initial recognition as: the premium, if any, received at initial recognition, plus the expected future premiums, if any, that are within the boundary of the existing contract. Alternative A: Do not require discounting (or interest accretion in the measurement of the liability for remaining coverage (consistent with current GAAP in most jurisdictions). Alternative B: Require discounting and interest accretion in the measurement of the liability for remaining coverage *only* for contracts that have a significant financing component. As a practical expedient, do not discount the liability for remaining coverage for insurance contracts that have a coverage period less than one year. Alternative B is consistent with the proposals in the revenue recognition project.
acquisition costs (paragraphs 60 – 104)	The current definition of acquisition costs is "costs that vary with and are primarily related to the acquisition of insurance contracts." Costs that meet this definition are typically recognized as assets, amortized over time, and are referred to as deferred acquisition costs.[9]	Incremental acquisition costs are included in the present value of the fulfillment cash flows (i.e. they are included in the measurement of the liability for remaining coverage)	Directly attributable acquisition costs are included at inception in the measurement of the insurance contract liability, and are one factor in the calibration of the residual/single margin at inception.	Record incremental costs of obtaining a contract as an asset. As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.	**Measurement:** Alternative 1: Directly attributable costs (for the FASB, limited to successful acquisition efforts only), (consistent with the tentative decisions made under the building blocks approach) and permit expensing of non-incremental costs. Alternative 2: Include incremental costs and permit expensing all acquisition costs if the contract coverage period is one year or less (consistent with the revenue recognition exposure draft proposals). **Presentation:**

[8] The unearned premium reserve approach is currently used in the US and many other jurisdictions for short duration contracts.
[9] The staff does not know of any jurisdiction that distinguishes the definition or measurement of acquisition costs based on the type of insurance contract or the accounting model (short or long-duration) that is currently applied.

	Unearned Premium Reserve Approach[8]	Measurement proposed in the ED/DP	Measurement under the Building Block Approach	Revenue recognition proposals	Alternatives considered by staff
					Acquisition costs should be recognised as an asset (and thus the liability for remaining coverage should be presented gross of acquisition costs).

Appendix C – Illustrative journal entries for discounting the liability for remaining coverage

The following example illustrates the staff analysis assuming a premium of CU 1,200 that is received monthly and earned straight-line over a one-year coverage period with a discount rate of 5% (or CU 60). The example also assumes interest is accreted on the liability at 5%.

No discounting		
Day 1:		
Receivable (SFP)	1,200	
Liability for remaining coverage (SFP)		1,200
After 3 months:		
Cash (SFP)	300	
Receivable (SFP)		300
Liability for remaining coverage (SFP)	300	
Earned premium (SCI)		300
Discounting of both the receivable and liability		
Day 1:		
Receivable (SFP)	1,140	
Liability for remaining coverage (SFP)		1,140
After 3 months		
Cash (SFP)	300	
Receivable (SFP)		285
Interest income (SCI)		15
Liability for remaining coverage (SFP)	285	
Interest expense (SCI)	15	
Earned premium (SCI)		300
Discounting of the liability when premium received upfront in a contract with a significant financing component		
Day 1:		
Cash (SFP)	1,200	
Liability for remaining coverage (SFP)		1,200
After 3 months		
Interest expense	15	
Liability for remaining coverage (SFP)		15
Liability for remaining coverage (SFP)	315	
Earned premium[10]		315

[10] This amount contains earned premium of CU 300, plus a financing component of CU 15.

Appendix D – Interest Accretion Analysis

The following example illustrates an insurance contract with a premium written of CU 2,400 received upfront that is earned straight-line over a two-year coverage period. For the purpose of this example, it is assumed that this contract contains a significant financing component and therefore, should reflect the time value of money which is represented by the component of premiums earned titled, "premiums earned from financing." It also assumes investment in a CU 2,400 bond that yields 5% interest and matures after the two year coverage period. This example does not show the effect of interest accretion on the incurred claims.

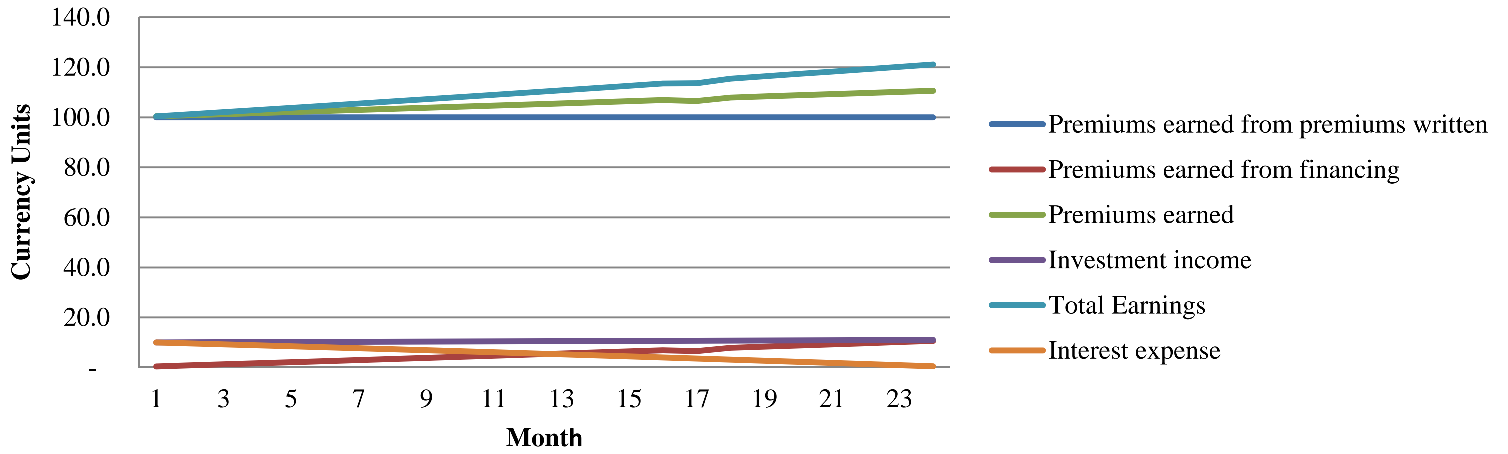
Month		**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
Beginning premium obligation balance		2,400	2,309.6	2,218	2,126	2,034	1,940	1,845	1,750	1,654	1,557	1,459	1,361
Interest Expense	5%	10.0	9.6	9.2	8.9	8.5	8.1	7.7	7.3	6.9	6.5	6.1	5.7
		2,410.0	2,319.2	2,227.6	2,135.2	2,042.0	1,948.0	1,853.2	1,757.5	1,661.0	1,563.7	1,465.5	1,366.5
Premiums earned from premiums written		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Premiums earned from financing		0.4	0.8	1.3	1.7	2.1	2.5	3.0	3.4	3.8	4.2	4.7	5.1
Premiums earned		100.4	100.8	101.3	101.7	102.1	102.5	103.0	103.4	103.8	104.2	104.7	105.1
Premium obligation from premiums written		2,300.0	2,200.0	2,100.0	2,000.0	1,900.0	1,800.0	1,700.0	1,600.0	1,500.0	1,400.0	1,300.0	1,200.0
Premium obligation from interest income		9.6	18.4	26.4	33.5	39.9	45.5	50.2	54.1	57.2	59.4	60.8	61.4
Ending premium obligation		2,309.6	2,218.4	2,126.4	2,033.5	1,939.9	1,845.5	1,750.2	1,654.1	1,557.2	1,459.4	1,360.8	1,261.4
Investments		2,400.0	2,410.0	2,420.0	2,430.1	2,440.3	2,450.4	2,460.6	2,470.9	2,481.2	2,491.5	2,501.9	2,512.3
Investment income	5%	10.00	10.04	10.08	10.13	10.17	10.21	10.25	10.30	10.34	10.38	10.42	10.47
Statement of comprehensive income													
Premiums earned from premiums written		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Interest expense		(10.0)	(9.6)	(9.2)	(8.9)	(8.5)	(8.1)	(7.7)	(7.3)	(6.9)	(6.5)	(6.1)	(5.7)
Premiums earned from interest income		0.4	0.8	1.3	1.7	2.1	2.5	3.0	3.4	3.8	4.2	4.7	5.1
Investment income		10.00	10.04	10.08	10.13	10.17	10.21	10.25	10.30	10.34	10.38	10.42	10.47
		100.4	101.3	102.1	102.9	103.8	104.7	105.5	106.4	107.3	108.1	109.0	109.9

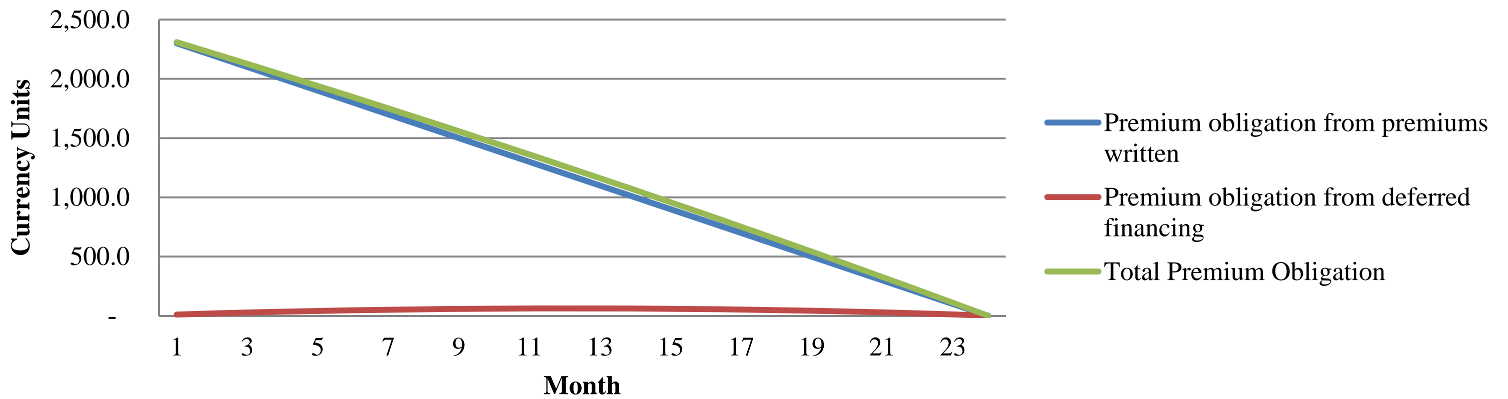
Month	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20**	**21**	**22**	**23**	**24**	**Total**

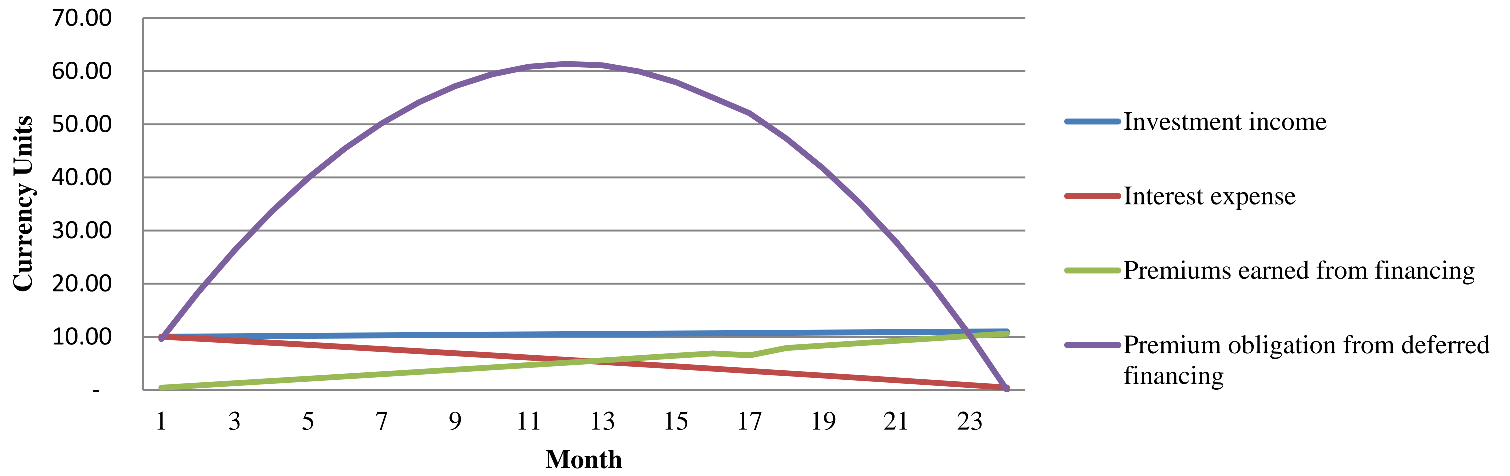
Beginning premium obligation balance		1,261	1,161	1,060	958	855	752	647	542	435	328	219	110	
Interest Expense	5%	5.3	4.8	4.4	4.0	3.6	3.1	2.7	2.3	1.8	1.4	0.9	0.5	129.1
		1,266.7	1,165.9	1,064.4	961.9	858.6	755.2	650.0	543.9	437.0	329.1	220.3	110.6	
Premiums earned from premiums written		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	2,400.0
Premiums earned from financing		5.6	6.0	6.4	6.9	6.5	7.9	8.3	8.8	9.2	9.7	10.2	10.6	129.1
Premiums earned		105.6	106.0	106.4	106.9	106.5	107.9	108.3	108.8	109.2	109.7	110.2	110.6	2,529.1
Premium obligation from premiums written		1,100.0	1,000.0	900.0	800.0	700.0	600.0	500.0	400.0	300.0	200.0	100.0	-	
Premium obligation from interest income		61.1	59.9	57.9	55.0	52.1	47.3	41.7	35.2	27.7	19.4	10.2	-	
Ending premium obligation		1,161.1	1,059.9	957.9	855.0	752.1	647.3	541.7	435.2	327.7	219.4	110.2	(0.0)	
Investments		2,522.8	2,533.3	2,543.9	2,554.5	2,565.1	2,575.8	2,586.5	2,597.3	2,608.1	2,619.0	2,629.9	2,640.9	
Investment income	5%	10.5	10.6	10.6	10.6	10.7	10.7	10.8	10.8	10.9	10.9	11.0	11.0	251.9

Statement of comprehensive income

Premiums earned from premiums written	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	2,400.0
Interest expense	(5.3)	(4.8)	(4.4)	(4.0)	(3.6)	(3.1)	(2.7)	(2.3)	(1.8)	(1.4)	(0.9)	(0.5)	(129.1)
Premiums earned from interest income	5.6	6.0	6.4	6.9	6.5	7.9	8.3	8.8	9.2	9.7	10.2	10.6	129.1
Investment income	10.5	10.6	10.6	10.6	10.7	10.7	10.8	10.8	10.9	10.9	11.0	11.0	251.9
	110.8	111.7	112.6	113.5	113.6	115.5	116.4	117.4	118.3	119.2	120.2	121.2	2,651.9


Statement of Comprehensive Income
140.0
120.0
100.0
80.0
60.0
40.0
20.0
-
Currency Units
1
3
5
7
9
11
13
15
17
19
21
23
Month
Premiums earned from premiums written
Premiums earned from financing
Premiums earned
Investment income
Total Earnings
Interest expense


Statement of Financial Position
2,500.0
2,000.0
1,500.0
1,000.0
500.0
-
Currency Units
1
3
5
7
9
11
13
15
17
19
21
23
Month
Premium obligation from premiums written
Premium obligation from deferred financing
Total Premium Obligation


Impact of Accretion of Interest
Currency Units
70.00
60.00
50.00
40.00
30.00
20.00
10.00
-
1
3
5
7
9
11
13
15
17
19
21
23
Month
Investment income
Interest expense
Premiums earned from financing
Premium obligation from deferred financing